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THE 1994 JOINT ECONOMIC REPORT

REPORT

OF THE

JOINT ECONOMIC COMMITTEE
CONGRESS OF THE UNITED STATES

ON THE

1994 ECONOMIC REPORT
OF THE PRESIDENT

TOGETHER WITH

MINORITY VIEWS

May 9, 1994.—Committed to the Committee of the Whole House on the State of the Union and ordered to be printed

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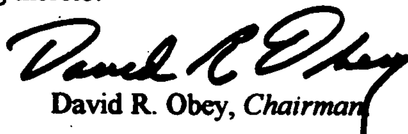
LETTER OF TRANSMITTAL

May 9, 1994.

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 *1994 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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THE 1994 JOINT ECONOMIC REPORT ON THE 1994 ECONOMIC REPORT OF THE PRESIDENT

May 9, 1994.—Committed to the Committee of the Whole House on the State of the Union and ordered to be printed

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

REPORT

together with

MINORITY VIEWS

I

INTRODUCTION

Last year, the *Annual Report* from the Joint Economic Committee spelled out the problems facing the American economy, identifying four deficits that had grown during the 1980s: financial, investment, income and growth. While calling attention to the problem of the federal budget deficit, the Committee report stated:

> *The American people expect government to make tough choices and tackle the Federal Government's financial deficit. They also expect effective responses to the other deficits which are eroding the foundation of our economy.*

As the economy moves further into 1994, it is clear that substantial progress has been made in addressing those deficits, but it is equally clear that much more needs to be done. The economic problems of the 1980s will not be wiped away in a single year's time.

Specifically, there has been major progress in getting the federal budget deficit under control, and in restoring economic and job growth. Private investment has also begun to recover. But serious challenges remain in restoring adequate levels of public investment, and in helping to get real incomes growing again for the majority of Americans, especially those without a four-year college education.

The year 1993 saw a healthy turnaround in the American economy, fueled in large part by a combination of responsible fiscal policy and appropriate monetary policy. Congress enacted the President's program of significant deficit reduction, balanced between spending cuts and tax increases concentrated on the wealthiest Americans. At the same time, the Federal Reserve kept interest rates down, helping to offset the contractionary impact of the deficit reduction package. These low interest rates were easy to justify, because inflation fell for the third year in a row, and was the lowest during a recovery since the mid-1960s.

In 1994, the economy seems to be entering a period of sustained recovery, but policy makers must still be careful. It will be necessary for Congress to stay on course with the deficit reduction targets enacted last year, while at the same time not imposing significant new levels of contraction on the economy. The budget course laid out in last year's deficit reduction legislation is placing significant restraint on the economy.

But perhaps the greatest threat to sustained recovery would be continuing and unwarranted increases in interest rates. Economic policy in 1993 was successful because there was a balance—contractionary fiscal policy to reduce the federal deficit and accommodative monetary policy to encourage growth, especially in interest-sensitive sectors.

Fiscal policy remains contractionary in 1994, but recent increases in interest rates have driven long-term rates above their level at this time last year, apparently in part because of their impact on highly leveraged financial markets. With no serious signs of significant inflationary pressures, interest rates should stay low in order to offset fiscal contraction.

Even if appropriate policies help to keep the cyclical recovery going, the American economy faces serious long-term structural challenges. Foremost among these is the crisis in health care. Health costs continue to consume too large a share of GDP, crowding out wage growth and business investment, but without providing adquate health care coverage for all Americans. Comprehensive health care reform will be necessary to restrain rising cost while improving access to care.

A second major challenge is the continuing low level of public investment, in such areas as infrastructure and education and training. Without more and better focused investment in these economic necessitites, the American economy will not reach its full growth potential, and the lives of many Americans will be stunted unnecessarily.

Public investment is an essential component of addressing the final, and most important structural challenge—restoring real income growth for the majority of the American people. For in spite of the impressive economic and policy successes of 1993, real family income remains stagnant, after having been on a downward slope for almost two decades.

This problem is made worse by inequality. The losses in real income have been concentrated on families in the middle and lower end of the economic spectrum, especially those with less than a four-year college education. Minorities, especially African-Americans and Hispanics, have suffered even more, as the impact on middle and lower income brackets has been magnified by the effects of industrial change and discrimination.

This report contains three major sections. First, a review of the economy in 1993, including the deficit reduction package enacted by Congress, shows the depth of the Nation's economic problems entering 1993 and the progress that has been made. Second, the outlook for 1994 discusses fiscal and monetary policy, concentrating on the cyclical forecast and the threats to continued recovery. Finally, the third section details the major structural challenges that face the American economy in the long term.

II

THE ECONOMY IN 1993: WORKING OFF THE DEBTS OF THE 1980S

The economy in 1994 seems to be entering a sustained recovery, but it will take some time to overcome the problems of the 1980s. It is important to understand the depth of the economic problems that the Nation faced during 1993, in order to understand the economic challenges that still lie ahead. Slow economic growth between 1989 and 1992 was the legacy of the unsustainable economic policies and conditions of the 1980s.

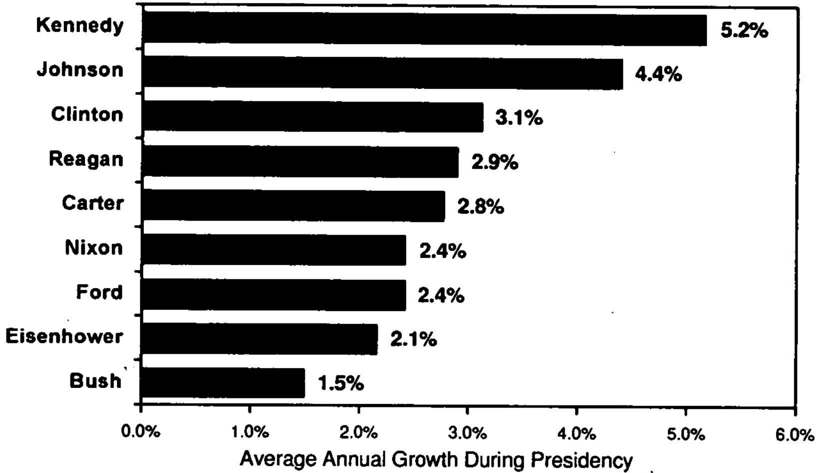
1988-1992: HISTORICALLY POOR ECONOMIC PERFORMANCE

Since World War II, the economy has grown at an average annual rate of 3.3 percent. During that time, real gross domestic product (GDP) more than tripled. This long period of strong economic growth was punctuated by eight recessions—including particularly severe recessions in 1948-49, 1973-75 and 1981-82—but robust growth during expansion periods more than compensated for lost output during downturns.

Economic growth during the various administrations was quite varied. Growth was particularly strong under President Kennedy, when GDP rose at an annual rate of 4.7 percent, followed closely by 4.6 percent growth under President Johnson. Growth was weakest under President Eisenhower at 2.1 percent, followed by both Presidents Nixon and Ford at 2.4 percent (see Chart 1).

But economic growth from 1989 through 1992 was the lowest since World War II. During those four years, real GDP grew at an annual rate of less than 1.5 percent. This was less than half the postwar average and the weakest economic growth during any Administration since that of Herbert Hoover.

CHART 1

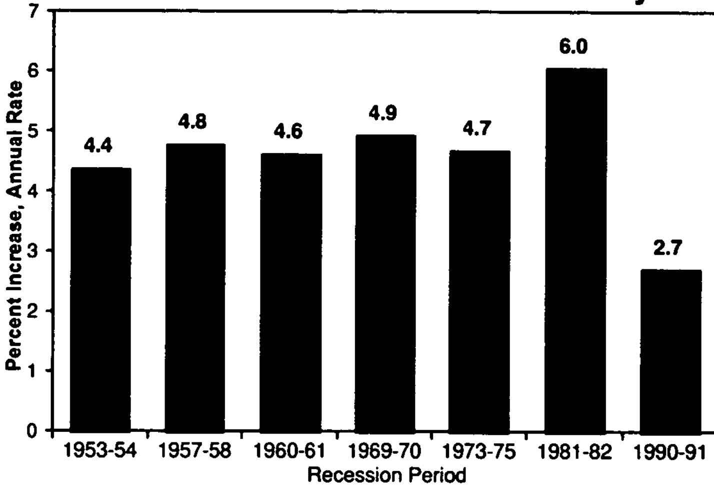


Sources: Department of Commerce; Joint Economic Committee.

The recession from July 1990 through March 1991 was part of the problem, but not the entire story. Growth both before and after the recession also was well below normal. In fact, the recession, which by postwar standards was relatively mild and short, was followed by the weakest recovery in the postwar period. Economic growth during the first seven quarters of the recovery—from the second quarter of 1991 through the fourth quarter of 1992—was the lowest of any postwar recovery (see Chart 2). Output rose at an annual rate of 2.7 percent, versus an average of 5.0 percent for the previous six recoveries[1].

[1]The recovery from the recession of 1948-49, when real GDP grew at an annual rate of 11.9 percent, is excluded from the average. If the recovery from the 1948-49 recession were included, average growth during the first seven quarters of postwar recoveries would be 6.0 percent.

CHART 2



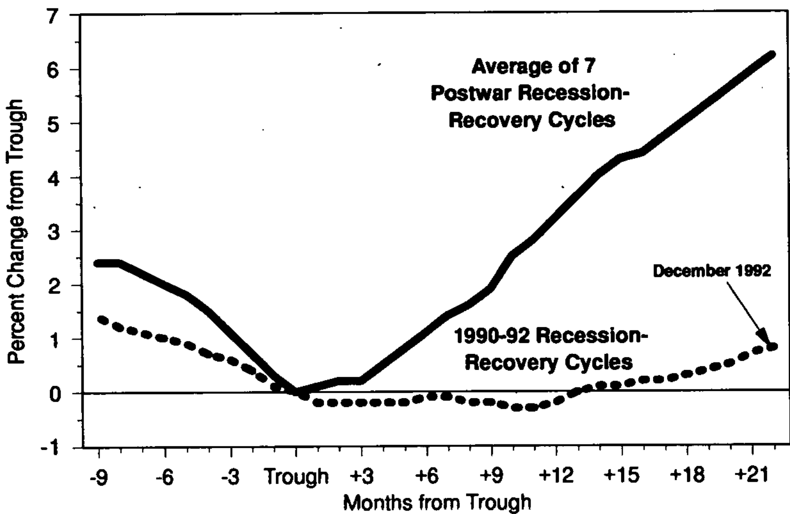
Sources: Department of Commerce; Joint Economic Committee.

This prolonged economic lethargy had a serious impact on job creation. From 1989 through 1992, the number of jobs on nonfarm payrolls rose by only 40 percent of the postwar average. In the private sector, the rate of job creation from 1989 through 1992 was only one-quarter of the postwar average. During this time, manufacturing jobs disappeared at a rate of 32,000 per month, the equivalent of losing one Fortune 500 industrial firm per month for four straight years. The total loss of manufacturing jobs came to more than 1.5 million, and 700,000 construction jobs were also lost.

While the 1990-91 recession hurt employment, the ensuing recovery did little to help. During previous business cycles, the recession trough marked the end of economic decline and job loss and the beginning of rapid recovery and job growth. On average, growth was so strong coming out of previous postwar recessions that it took only 10 months for all the jobs lost during the downturn to be restored during the ensuing recovery.

But the recovery from the 1990-91 recession was much weaker. For 12 months following the official end of the recession, job loss actually continued instead of reversing. Overall, job growth during the recovery period was only one-tenth as strong as that of the average postwar recovery (see Chart 3). By December 1992, the 21st month after the recession's trough, the economy had restored only half the jobs that had been lost during the recession. This anemic phase of the recovery period was unprecedented and gave rise to a new term —the "jobs recession."

CHART 3



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

The composition of job growth during the recovery also was a source of concern. Of the 715,000 jobs that were created between March 1991 and December 1992, almost 60 percent were on government payrolls, primarily those of local governments. The private sector experienced a net job gain of only 300,000, a monthly average of 14,000. An increase of 1.3 million jobs in the service-producing sectors of the economy barely offset a loss of almost 1 million in goods-producing sectors, such as construction and manufacturing.

Aside from government, the strongest job growth occurred in health care, the personnel supply industry (comprised primarily of temporary help agencies) and in restaurants and other eating and drinking establishments. Even though the economy was technically in a recovery, good jobs were still disappearing and part-time and temporary jobs were expanding.

High unemployment went hand-in-hand with slow job growth. Between the pre-recession peak of July 1990 and the recession trough of March 1991, the unemployment rate rose from 5.4 percent to 6.8 percent. However, the unemployment rate did not start to fall until long after the recession trough, in contrast to previous recoveries. Instead, the unemployment rate continued to rise for an additional sixteen months, peaking at 7.7 percent in June 1992[2]. By this time, almost 9.8 million people were jobless, more than at any time in the postwar period, with the sole exception of the 1981-82 recession.

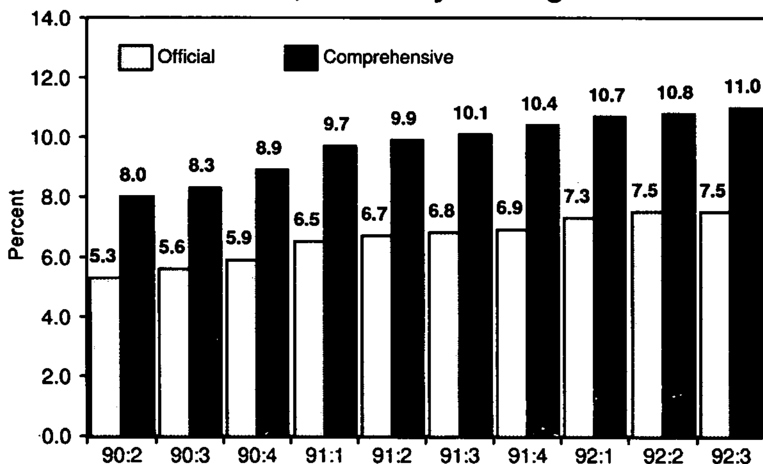
Besides the unemployed, many others were affected by slow economic growth and anemic recovery in 1991-92. By the middle of 1992, more than one million people who wanted jobs had become so discouraged that they gave up the search for work and thus were not counted as officially unemployed. Another 6.5 million were working part-time because they could not find full-time jobs. Altogether, almost 17 million individuals were either wholly or partially unemployed at any one

[2] These figures should not be compared with the current unemployment rate of 6.5 percent. In January 1994, the Bureau of Labor Statistics implemented revised survey procedures for its monthly Census of Population from which it computes the unemployment rate. Data from the new procedures are not comparable to data from the old. If BLS had been using the new survey procedures during and following the 1990-91 recession, it is likely that the peak unemployment rate in June 1992 would have been 8.2 percent or higher.

time during 1992. When these were included in a more comprehensive measure of unemployment, the rate hit a peak of 11.0 percent in the third quarter of 1992 (see Chart 4).

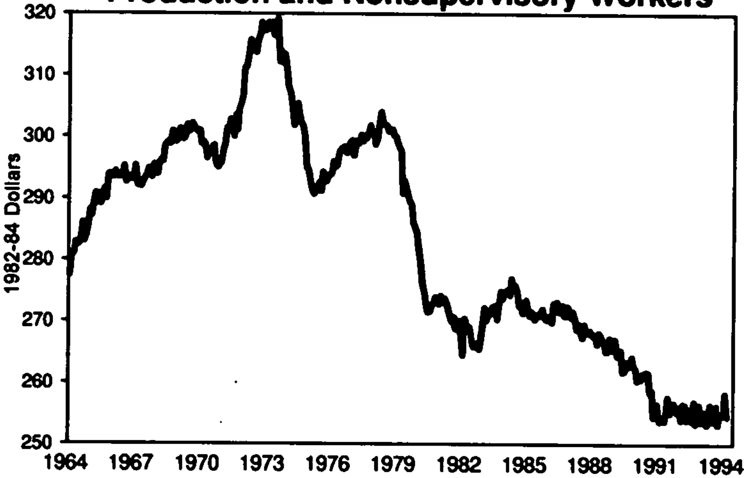
For those who did have jobs, there was a problem of declining incomes. For most workers, especially those without a college education, wages failed to keep pace with inflation and living standards were falling. Real average hourly earnings for production and nonsupervisory workers—approximately 80 percent of the total work force—fell by almost 4 percent from 1989 to 1992, while real average weekly earnings fell by more than 5 percent (see Chart 5). Both measures were lower at the end of 1992 than at any time since the BLS began collecting wage data in 1964. Even when fringe benefits are added to real hourly wages, worker compensation rose only a half a percent per year from 1989 to 1992.

CHART 4



Source: Department of Labor, Bureau of Labor Statistics.

CHART 5



Source: Department of Labor, Bureau of Labor Statistics.

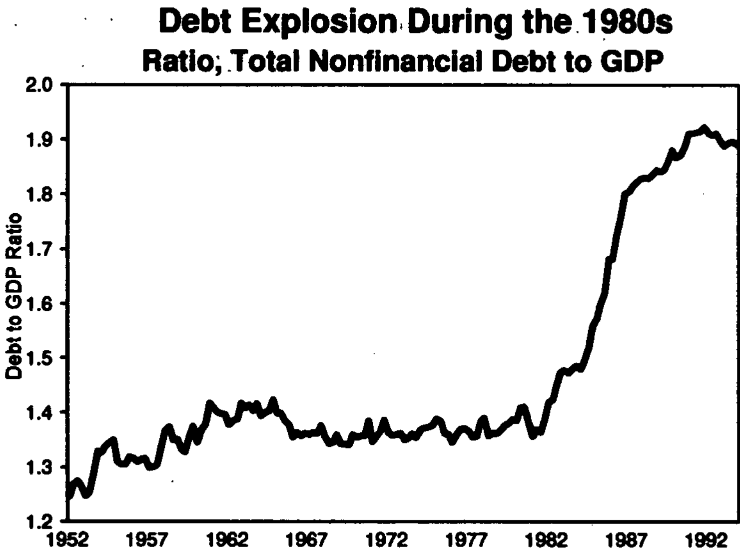
Family incomes also suffered substantially. From 1989 through 1992, real median weekly earnings of all families with at least one member in the labor force fell by almost 3.5 percent, almost $20 per week in 1982 dollars. For families with only one earner, the decline was even worse, 6.9 percent. Many families compensated for the fall in income by sending more members into the labor force.

LEGACY OF THE 1980s

Slow economic growth between 1989 and 1992 was in significant measure the legacy of the unsustainable economic policies and conditions of the 1980s. Among the most glaring was the rapid growth of debt, both public and private.

For most of the postwar period prior to the 1980s, the total debt of the nonfinancial sectors of the U.S. economy, both public and private, was a fairly constant 1.4 times the level of gross domestic product (see Chart 6).

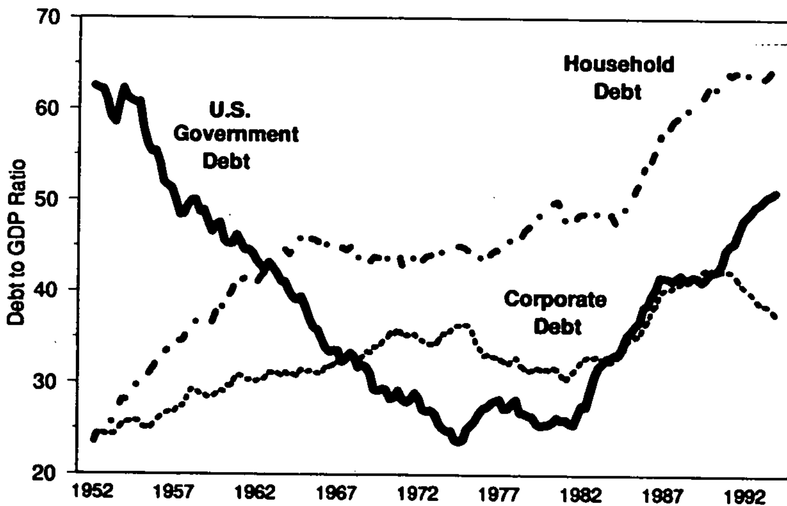
CHART 6



Source: Federal Reserve Flow of Funds.

This stability was the result of a steady decline in the debt of the Federal Government, which fell from 60 percent of GDP during the early 1950s to below 25 percent of GDP by the mid-1970s (see Chart 7). Small federal deficits and strong economic growth, particularly during the 1960s, shrank the relative size of the federal debt sufficiently to offset the gradual increase in the debt of households and businesses. Household debt rose from less than 25 percent to 45 percent of GDP, while the debt of nonfinancial corporations rose from just under 25 percent of GDP to somewhat above 35 percent. The net effect of the rise in private debt and decline in Federal Government debt was to keep the ratio of debt to GDP at an almost constant 1.4 percent.

CHART 7



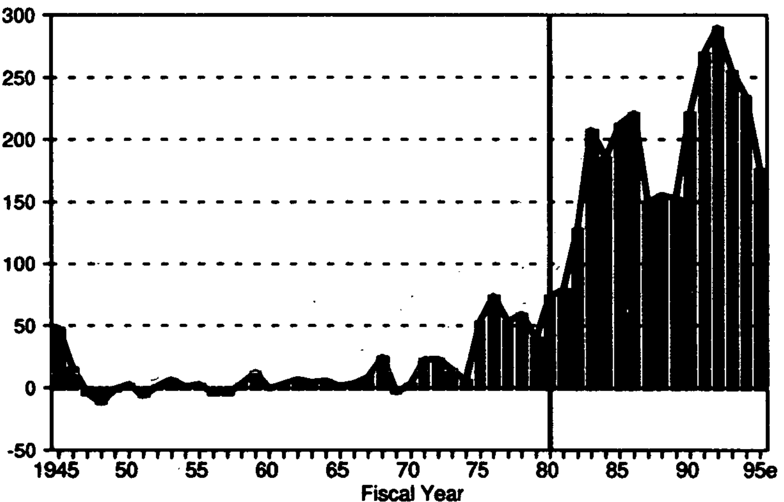
Source: Federal Reserve Flow of Funds.

However, beginning in 1982, total debt began to explode, rising by the end of 1989 to almost 1.9 times GDP. A major contributor was the debt of the Federal Government; the federal debt went from 31 percent of GDP in 1982 to 42 percent by the end of 1989. This resulted from the sharp increase in the federal deficit (see Chart 8).

The debt explosion occurred for numerous reasons, including the Reagan tax cuts enacted in 1981. In combination with the expansion of federal spending for defense, the tax cut resulted in a skyrocketing federal deficit that went from $40 billion in fiscal 1979 to $207 billion in 1983.

In addition, household debt rose dramatically, from just under 49 percent of GDP in 1982 to almost 65 percent by the end of 1989, with virtually all of the increase coming in the form of home mortgages. At the same time, the debt of corporate businesses increased significantly—from just over 32 percent of GDP in 1982 to just over 42 percent by the end of the 1980s.

CHART 8



Source: Office of Management & Budget.

Economic growth of the 1980s depended far too much on rising debt. It was a bubble prosperity destined to pop when the economy could not absorb any more. By the late 1980s, a number of forces were at work to deflate the economy. The building boom of the 1980s came to a halt, first in New England and then in the rest of the country. The 1986 Tax Reform Act reversed some of the lucrative tax breaks for real estate put in place in the 1981 tax law, but primarily the industry had simply overbuilt office and commercial space during the 1980s. Supply had greatly outrun demand. Rents declined in many markets, as owners of "see-through" buildings—those built but empty—tried to attract tenants. As rents declined, so did real estate values.

The troubles in real estate had a significant impact on banks and other financial institutions. The rapid increase in nonperforming loans severely eroded the value of bank portfolios. Many banks had to close because capital was inadequate to cover losses. Most others had to restrict new lending, both for real estate and other activities, to concentrate on rebuilding capital-to-lending ratios to an adequate level. The resulting "credit crunch" depressed economic activity from the late 1980s through the early 1990s.

Economic policy, both fiscal and monetary, also contributed to the eventual downturn. There is a widespread misconception among the public that a large budget deficit is always stimulative. But when the deficit is being reduced through spending cuts or tax increases, fiscal policy has a depressing effect regardless of the initial level of the deficit. Stimulus occurs only when the deficit is growing over the previous year.

Therefore, the best time to undertake deficit reduction is when other factors favor strong growth. Such an opportunity was missed during the mid-1980s, largely because the Reagan Administration's "dead-on-arrival" budgets stymied rather than fostered progress on deficit reduction. It is noteworthy that throughout the 1980s, Congress enacted spending below the level requested by President Reagan.

As the 1980s wore on, it became increasingly apparent that Congress would have to take action to reduce the deficit. By 1990, when the Congress enacted a round of serious deficit reduction, growth had slowed perceptibly, and deficit reduction put further downward pressure on the economy.

The debt overhang for business and households meant that any reduction in disposable income would have a more powerful than normal effect on current spending, given the need to pay principal and interest on debt that had been incurred earlier in the decade.

After a brief period of increased liquidity following the October 1987 stock market crash, interest rates were raised through the middle of 1989 in a vain attempt to steer the economy to a soft landing. Although interest rates began to drift down during the second half of 1989, the reversal came too late to prevent a downturn in interest-sensitive sectors of the economy, especially homebuilding, business investment and consumer spending for durable goods.

Even after the economy went into recession in mid-1990, the Fed's move toward monetary stimulus was judged by many to be too little and too late. Although the economy was being buffeted, according to Federal Reserve Chaiman Alan Greenspan, by a "50-mile-per-hour headwind," the Fed reduced interest rates only half as rapidly as it did on average during other postwar recessions. Not until the end of 1992 was the Federal Funds rate cut to 3 percent.

The domestic pressures on the U.S. economy were compounded by slow growth and recession overseas. The Japanese Central Bank tightened credit and precipitated a plunge in stock prices and real estate values, which ended their boom. In Europe, the collapse of the Soviet Union and the reunification of Germany led to a rising German budget deficit as resources were poured into rebuilding the former East Germany. The Bundesbank sought to put a clamp on inflation with higher interest rates, which spread through Europe, putting Western Europe into recession. These downturns in Europe and Japan reinforced the weakness in the U.S. economy by depressing demand for U.S. exports.

1993's TURNAROUND

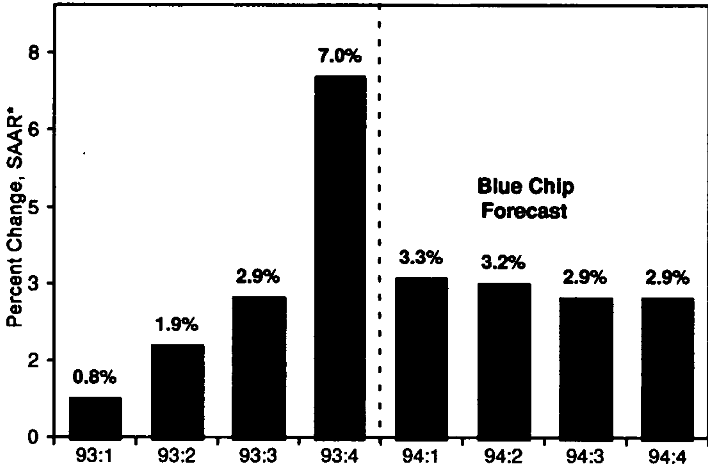
In early 1993, as the Clinton Administration was preparing to take office, the American economy faced an uncertain future. For much of the previous four years, economic growth had been anemic. Job growth had been abysmal. Households were growing increasingly pessimistic about the nation's, and their own, economic future. Economic policy, after years of gridlock and rising budget deficits, appeared to be floundering. Of most immediate concern to the new Administration was restoring economic growth and speeding the creation of new jobs.

The incoming Administration had to deal with a complex set of cyclical and structural problems. For the short-term, the economy needed a package of policies to strengthen the recovery and stimulate the economy. For the longer-term, the most important problem was to reduce the federal budget deficit while increasing government investment spending. The President's economic program was designed to address both goals.

Although there was a statistical increase in the growth rate in 1992, many analysts agreed that the composition of growth made it unsustainable. Consumer spending raced ahead of both job and income growth, particularly during the fourth quarter as households experienced a surge in confidence following the Presidential election. Two-thirds of the growth of output resulted from an increase in consumer spending, largely for nondurables and services. Business investment accounted for less than 15 percent of fourth quarter growth. And growth fell sharply in the first quarter of 1993, confirming analysts' doubts.

In contrast, economic growth during 1993 was more sustainable. As the President's deficit reduction program moved through Congress, long-term interest rates declined, reaching their lowest level in almost three decades by the end of the year. As rates declined, economic growth picked up, from a low of 0.8 percent at an annual rate during the first quarter of 1993, to 7.0 percent during the fourth quarter—the fastest growth to continue in almost 10 years. Of course, no economist expects growth at that level, but forecasts for 1994 do indicate continued solid growth. Overall, during the first year of the Clinton administration, the economy grew by 3.1 percent (see Chart 9).

CHART 9

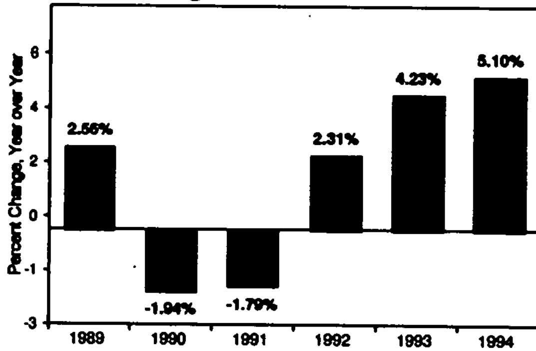


*SAAR = seasonally adjusted annual rate.
Sources: Department of Commerce; Blue Chip Economic Indicators.

The growth in 1993-94 is based on solid trends. The economy is experiencing the strongest growth in industrial production in five years (see Chart 10). This has been matched by a sharp increase in business investment; spending for producers' durable equipment has jumped to a record level of 9 percent of GDP (see Chart 11). Housing starts, although off slightly because of unusually bad weather during January and February, have recently been at their highest level in five years (see Chart 12).

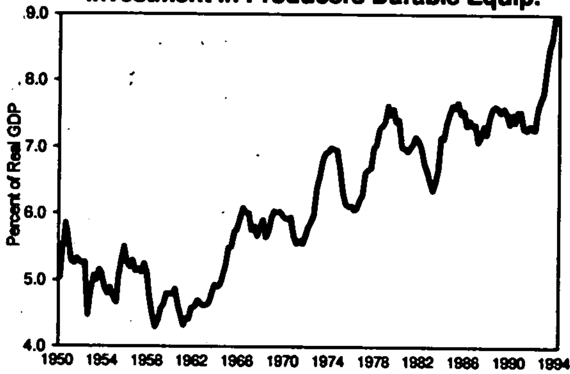
Analysts were impressed that much of the growth during the fourth quarter of 1993 was accounted for by increases in business investment, homebuilding, and household spending for consumer durables. All three sources of growth were stimulated by the decline in long-term interest rates during 1993.

CHART 10



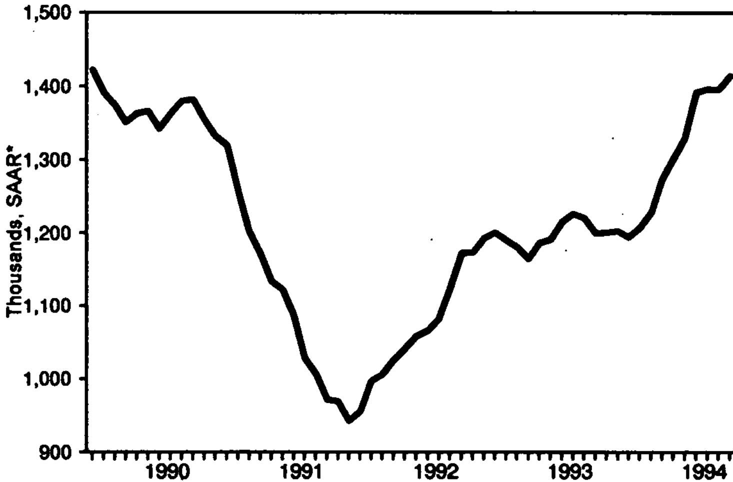
Note: 1994 is for the 12 months ending in March.
Source: Federal Reserve Board.

CHART 11



Source: Department of Commerce.

CHART 12



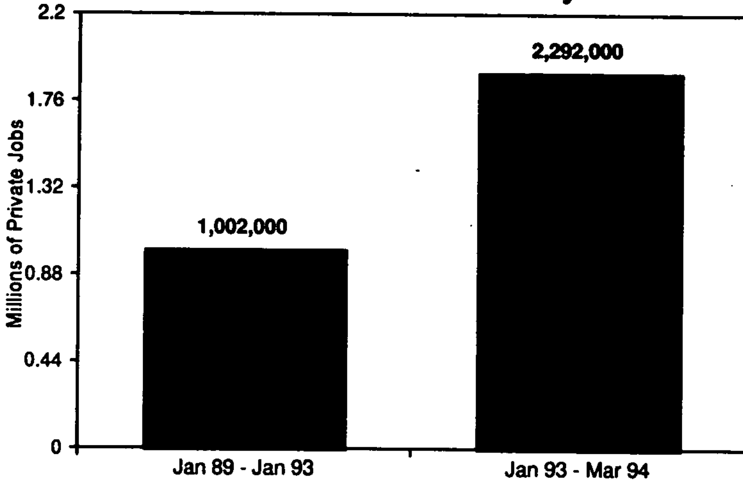
*SAAR = seasonally adjusted annual rate.
Source: Department of Commerce.

Among the most important economic developments of the past year has been the dramatic improvement in job growth.

Between January 1993 and March 1994, the number of jobs on nonfarm payrolls rose by 2.5 million, an average of almost 180,000 per month. This was double the rate for 1992 and the fastest pace of job growth in four years.

Most encouragingly, most of this job growth has come in the private sector of the economy, where payroll employment rose 2.3 million between January 1993 and March 1994, an average of 164,000 per month. This was triple the pace of 1992 and the fastest private sector job growth in five years. During this fourteen-month period, 1.3 million more private sector jobs were created than during the entire four preceding years (see Chart 13).

CHART 13

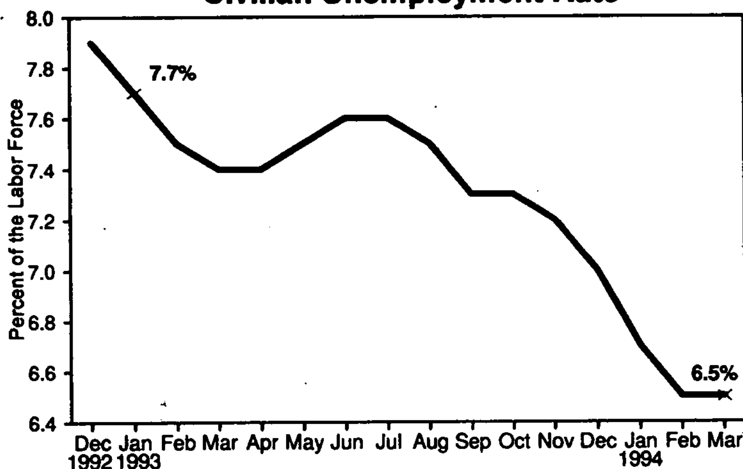


Source: Department of Labor, Bureau of Labor Statistics.

Among the most promising developments in recent months has been the growing number of jobs in manufacturing. During the four and a half years beginning in January 1989, employment in manufacturing dropped steadily by an average of 32,000 jobs per month. This decline ended in September 1993; since then, more than 88,000 jobs have been added to manufacturing payrolls.

The faster job growth in 1993 contributed to a significant reduction in unemployment. BLS estimates that if it had been using the new survey methodology to measure unemployment during 1993, the national unemployment rate would have fallen from 7.7 percent in January 1993 to 6.5 percent by March 1994 (see Chart 14). The decline between January 1993 and 1994 was the largest annual drop in unemployment in six years.

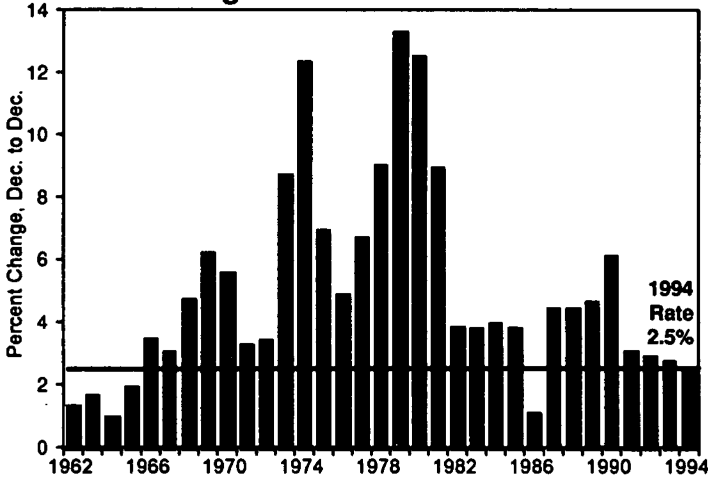
CHART 14



Note: Data for Dec. 1992-Dec. 1993 are from BLS model using new survey procedures
Source: Department of Labor, Bureau of Labor Statistics.

This economic growth has not been bought with inflation. In fact, inflation has been declining for the past three years. The inflation rate was 3.1 percent in 1991, 2.9 percent in 1992, and 2.7 percent in 1993. This was the lowest inflation rate since the early 1960s with the exception of 1986, when world oil prices collapsed. The low inflation continued into 1994; for the 12 months ending in March, the Consumer Price Index rose only 2.5 percent (see Chart 15).

CHART 15



Note: 1994 Rate: 12 months ending March 1994.
Source: Bureau of Labor Statistics.

The performance of the American economy is even more striking when compared to the slow growth in much of the rest of the world. In 1993, growth was negative in Germany and France and virtually zero in Japan. While 1994 will probably be better, growth is still expected to be very slow in other major economies, meaning that the United States is growing almost entirely on its own with little help from the rest of the world (see Chart 16).

Although it would be impossible to quantify all of the factors that contributed to the speedup of economic growth during 1993, enactment of the President's deficit reduction package was of major importance. The economy had been coming out of the 1990-91 recession during 1992, but the turnaround was agonizingly slow. There was very little job growth, particularly in comparison with previous economic recoveries. Consumers had little confidence in the economic outlook or their own prospects and were reluctant to purchase homes or other big-ticket items; and businesses were hesitant to make significant commitments to new capital spending.

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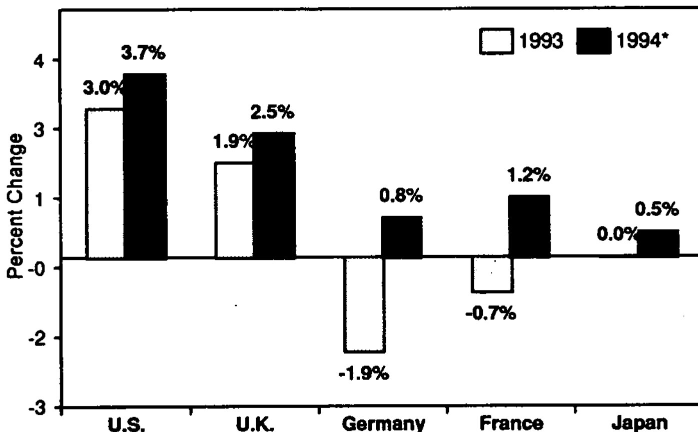
CHART 16



*Blue Chip Economic Indicator forecast April 1994.
Source: Blue Chip Economic Indicators.

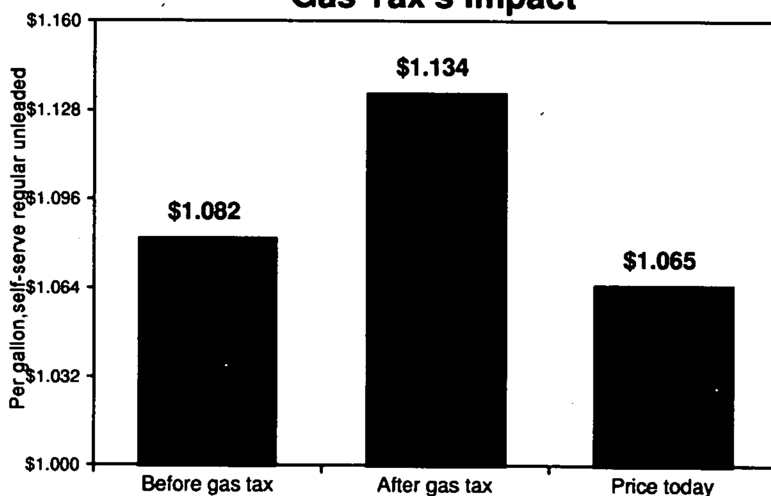
THE BUDGET RECONCILIATION PACKAGE

It took the election of a new President to generate the consumer and business optimism needed to launch a full-fledged recovery. Although the President's economic program included both a small stimulus program and a major deficit reduction plan, the crucial element was deficit reduction.

One of the Clinton Administration's priorities on taking office was to break gridlock and demonstrate that a properly working government could deal with the hard issues of deficit reduction. Normally, deficit reduction that includes significant spending cuts and tax increases, such as the program before Congress during the spring and summer of 1993, would have a depressing effect on economic activity. Both kinds of actions reduce business and household incomes and thus reduce aggregate demand and output.

But the Clinton plan minimized the fiscal drag normally associated with deficit reduction. First, virtually all of the tax increase fell on upper-income taxpayers. Only the top 1.2 percent of taxpayers by income were affected by the increase in the top income tax rate. These are the taxpayers best able to maintain spending even as their tax payments rise. More than 98 percent of all taxpayers experienced no increase in income taxes. The only tax increase on working age Americans was a 4.3 cent per gallon increase in the gasoline tax, which was more than offset by the decline in the price of oil late in 1993. Gasoline prices are lower now than before the tax went into affect (see Chart 17).

CHART 17



Sources: American Automobile Association.

With the plan's balance between taxes and spending cuts, enactment of the deficit reduction package had a significant impact on households and businesses. By August, when the program was passed by the Democrats in Congress, the gridlock that impeded deficit reduction throughout the 1980s was finally broken. Consumer and business confidence rose, helping to create a climate of optimism sufficient to overcome the fiscal drag directly attributable to the spending cuts and tax increases.

Deficit reduction also had a favorable impact on long-term interest rates. Analysts attribute the improvement in long-term rates during 1993 in large part to the deficit reduction package, as well as to the low inflation rate during the year and the favorable inflation outlook.

Interest rates, particularly long-term rates, can have a powerful impact on economic growth because they affect business investment decisions and household decisions to purchase new homes, automobiles and major appliances. This was especially true in 1993, because of the debt hangover from the 1980s.

During 1993, monetary policy played a supporting, but not a leading role, in strengthening the recovery. Although the Fed's slow pace of easing monetary policy during and following the 1990-91 recession was frequently criticized, by the end of 1992 the Fed had reduced the Federal Funds rate to a target range of 3 percent. And in 1993, this low rate helped offset the contractionary impact of the deficit reduction package.

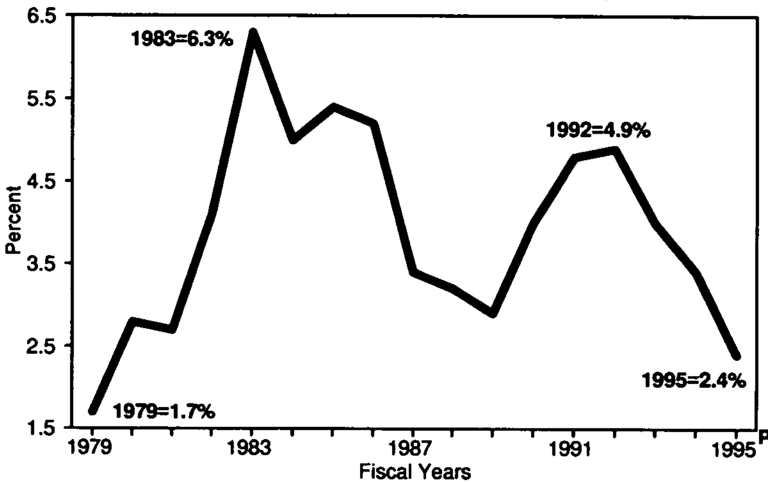
The reduction in the Federal Funds rate helped reduce other short-term and money market interest rates. Low short-term rates helped banks and other financial institutions strengthen their balance sheets and create the conditions for an expansion of credit. Since last year, the precipitous drop in commercial and industrial loans at commercial banks has ended.

Enacting the Clinton Administration's economic program to trim the federal portion of the debt overhang helped to reassure financial markets that Congress was committed to further deficit reduction. The distribution of the costs was a major issue as was the appropriate size of the bill.

Nevertheless, the economy was beginning to recover at a better pace. The stronger economy and the budget bill, together, have created the best budget outlook for more than a decade (see Chart 18).

These deficit measures include surpluses now being generated in the Social Security trust fund that are necessary to meet the costs of retirement of the Baby Boom generation. In FY93, that surplus was $49 billion (including interest earnings) or 0.7 percent of GDP.

CHART 18

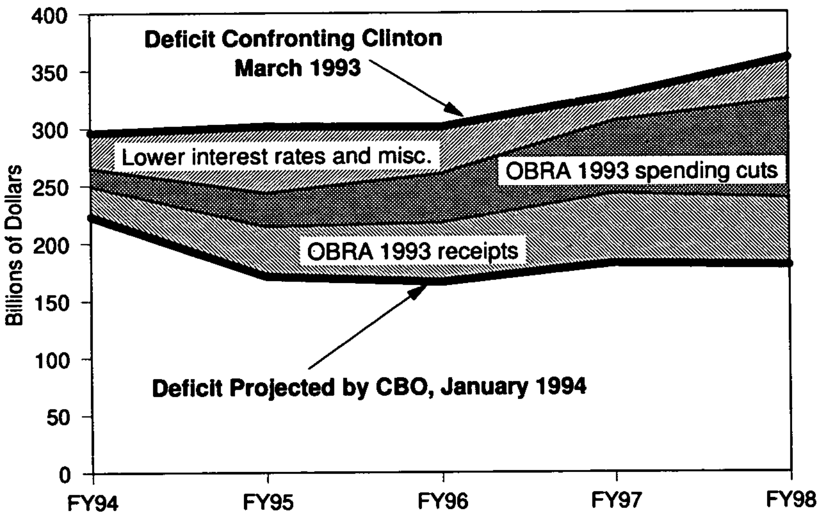


Source: Congressional Budget Office.

OBRA'93 largely followed the outlines of the President's deficit reduction proposals. It cut $477 billion over five years (1994-98) from the baseline deficits (see Chart 19). Of the $477 billion, about half was in spending cuts, across a broad array of programs. Stringent new caps on discretionary spending imposed a "hard freeze", allowing no increases for inflation and assuming some further reductions in defense spending. In total, discretionary spending through FY98 will be held almost $110 billion below the early 1993 baseline.

One key reason for the declining deficit is that Congress enacted a long list of spending cuts. Last year, Congress and the President cut over 500 programs below the spending level of previous years, saving $34 billion. Over the last 14 years, Congress has appropriated a total of $61.2 billion less than requested by presidents.

CHART 19



Source: Congressional Budget Office, March 1993, September 1993, and January 1994.

In this year's budget, that will continue. The President has proposed terminating over 100 programs and cutting below existing spending levels for more than 200 others to keep within the budget caps and free up funds for necessary investments. Congress will not accept every one of these cuts exactly as proposed, but will likely hit the spending reduction targets.

As part of deficit reduction, the President and Congress also raised revenues by imposing income tax increases on 1.4 million taxpayers earning over $140,000 in adjusted gross income (1.2 percent of the wealthiest Americans). At the same time, taxes were reduced for 15 million lower and middle-income working families, due to the expansion of the earned income tax credit (EITC). And CBO estimates that when the EITC is fully phased in, 21 million families will be eligible for the tax credit, a 42 percent increase.

III

OUTLOOK FOR 1994

ECONOMIC OUTLOOK FOR THE COMING YEAR

Most forecasters now expect the economy to continue on a steady growth path through the coming year, and into 1995. The greatest threat to continued growth is further increases in interest rates, which could choke off the recovery.

The recent spike in long-term interest rates, prompted by the actions of the Federal Reserve and linked to leverage in the financial markets, will cause the economy to slow somewhat. Thus far, growth appears to be vigorous enough to continue despite these negative impacts. But given the difficulties of establishing this recovery, and considering the central importance of interest-sensitive sectors, further increases in interest rates could threaten job and economic growth. The case against further sharp increases in interest rates is reinforced by forecasts of continuing low inflation.

In 1994, the major challenges are to keep a balance between contractionary fiscal policy and appropriate monetary policy. In addition, developments in the international economy could affect the recovery.

Forecasts For Growth

The vigorous 7 percent GDP growth in the fourth quarter of 1993 has prompted many economists to raise their forecasts for growth in 1994. In April, the Blue Chip consensus for real GDP growth in 1994 was raised to 3.7 percent. It is higher than the most recent forecasts by CBO (2.9 percent) and the Clinton Administration (3.1 percent), although there will probably be some upward revision of those forecasts soon.

The Blue Chip forecast is driven mostly by the unexpected strength of the last quarter in 1993. That jump in economic activity has created a surge

that will carry forward into 1994, although no economist expects growth to continue at a rate of 7 percent. Indeed, the Blue Chip consensus predicts that growth will slow in the latter part of 1994, with growth in 1995 predicted to be 2.9 percent.

These positive but moderate growth rates go hand in hand with continued forecasts that inflation will remain under control. In spite of the upward revision of the growth forecast for 1994, the Blue Chip forecasters do not see inflation problems looming. Recent forecasts for the Consumer Price Index (CPI) remain unchanged at 3.0 percent for 1994. Again, this forecast sends the same signals as CBO (2.7 percent increase in CPI for 1994), and the Administration (2.8 percent).

Interest Rates, Financial Leverage And Threats To Recovery

One factor that could affect these forecasts is the the Federal Reserve's move to boost interest rates, which set off a negative reaction in the financial markets. The Fed's rationale seems to have been the launching of a "pre-emptive strike" against virtually imperceptible inflation pressures, on the theory that such an action would calm the markets by reassuring that the Fed would remain on guard against inflation.

Since the end of 1993, and particularly since the Federal Reserve first raised the Federal Funds rate on February 4, long-term interest rates have moved upward. By the middle of April, mortgage interest rates were over 8 percent, while rates on high-grade corporate bonds were around 8 percent. Some increase in long-term rates was to be expected as the economy strengthened during the year and demand for funds went up. But uncertainty over future Federal Reserve policy contributed to the increase.

Prior to the Fed's actions, there was speculation that raising short-term interest rates might actually bring long rates down by reassuring markets. But up to this point, the reaction has been just the opposite. Between the peak on January 28 and a trough on April 4, prices of 30-year Treasury bonds fell by 14 percent, the biggest decline since 1987. This pushed interest rates on the 30-year bond up to 7.4 percent, before rates settled back slightly to around 7.2 percent.

The sharp increase in interest rates has rattled the municipal bond market, creating problems for state and local governments. It has led to higher interest payments on everything from home mortgages to consumer credit, which would reduce spending power in the economy.

The necessity of the Fed's actions have been questioned by many analysts, especially when considering continuing low inflation. For example, the Blue Chip financial forecasts anticipate unit labor cost growth of only 1.7 percent in 1994, with CPI growth of 2.8 percent. This would continue the low inflation of the past several years, and does not signal any significant increase in inflationary pressure.

The increase in interest rates may have been exacerbated by problems associated with speculation in the bond market. For example, so-called "hedge funds" borrowed heavily last year to buy bonds on very thin margins, in the anticipation that rates would stay down. When the Fed raised interest rates slightly, many of these speculative investors sold bonds to raise cash to cover their leveraged positions. This wave of selling put further pressure on bond prices, helping to create further concern in the markets. In early April, one insurance company analyst estimated that portfolio losses for insurance firms alone due to these interest rate increases is around $16 billion, close to the $16.5 billion of losses caused by Hurricane Andrew. He quipped, "I'm starting to call this Hurricane Greenspan."

The interaction of financial leverage with interest rate increases by the Fed may be the single biggest danger to continued economic recovery. High leverage makes the financial structure very brittle, and means that there can be sharp ripple effects in the market from seemingly small changes. For example, one group of so-called hedge funds had to liquidate its positions as interest rates rose, which in turn caused a sharp drop in mortgage-backed security (MBS) prices. This price collapse has reportedly caused significant losses to major firms that trade in the MBS market.

So instead of calming the financial markets, the Fed's actions seem to have made them more nervous. Because of the importance of interest-sensitive sectors to this recovery, the Fed must move very carefully in the coming months in order to avoid the danger of producing further counterproductive effects. This need for caution is underscored by the continuing contractionary fiscal position of the federal budget, as deficits remain on their downward glide path.

FISCAL POLICY

The forecast that the economy will continue to expand in 1994 and 1995 shows the wisdom of moving immediately in 1993 to tackle the deficit problem. Timing was crucial because deficit reduction directly imposes short-term contraction on the economy, even though it may permit better long-term prospects for growth. Contraction occurs because lower federal spending and higher taxes cut into business sales and siphon purchasing power away from private spenders. It is clear, however, that thus far in 1993 and 1994, deficit reduction's drag on growth has been offset by positive pro-growth developments.

The timing was good because (1) the "headwinds" that had been holding back recovery were diminishing, (2) the belated monetary stimulus the Federal Reserve provided in the wake of the past recession was having an impact, and (3) a coherent fiscal policy itself boosted public confidence, as reflected in financial markets and private spending.

The major overhang of a high-debt service burden going into the 1990 recession had receded somewhat as households slowed their spending during the recession. Also, by the early 1990s, firms had stopped the major financial restructurings that actually extinguished equity and substituted debt in the late 1980s.

In combination, these developments meant that debt service burdens were beginning to ease for both the household and the corporate business sector (see Charts 20 and 21). Overbuilding in the real estate market began to be absorbed, as indicated by declining rental vacancy rates. And the economies of our foreign trading partners appear to be turning around. Although they are growing much more slowly than the U.S. economy, the simple fact that they are no longer declining improves the U.S. export picture.

CHART 20

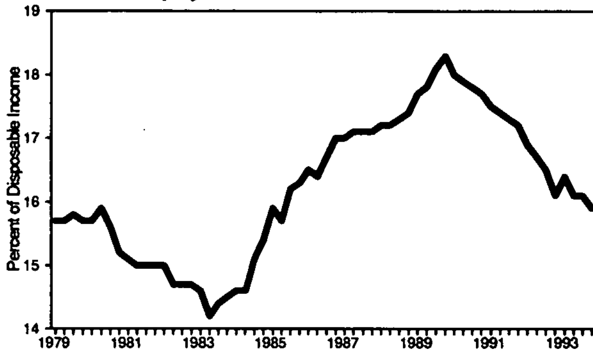
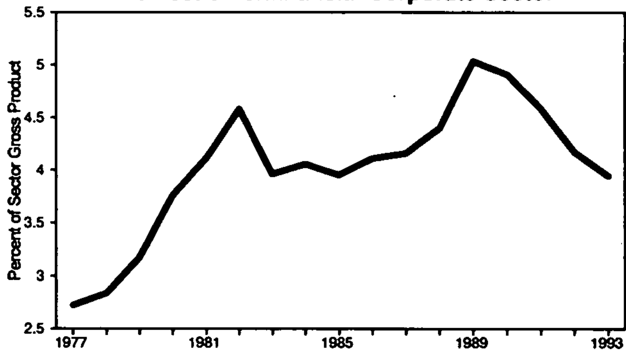


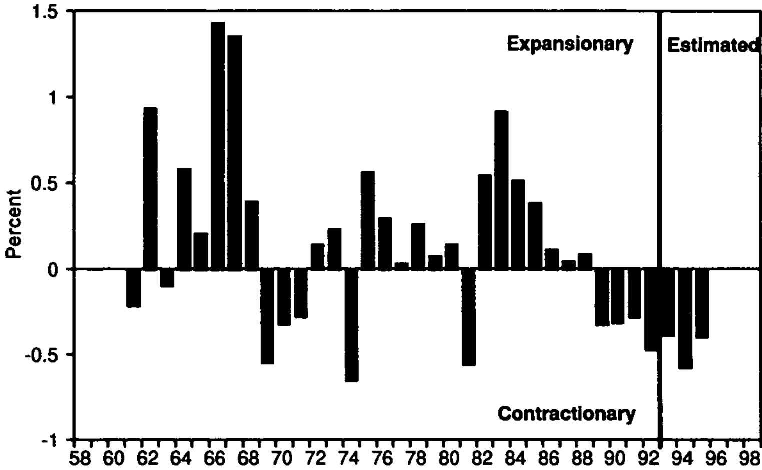
CHART 21



In other words, the economy could absorb some contraction through a balanced program of tax increases and budget cuts.

But deficit reduction is not a panacea. Policymakers must realize that the amount of fiscal restraint being imposed in 1994 is fairly substantial (see Chart 22). After allowing for the lesser direct effect of taxes than of government purchases on total spending, the outlay and revenue sides of the budget share about evenly in the fiscal restraint this year and next.

CHART 22



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

On the spending side, the major element of restraint comes from defense spending. The Congressional Budget Office's (CBO) estimates of defense purchases for fiscal 1994 imply a real decline of almost 8 percent. This decline has its greatest direct impact on the two coasts of the nation, where the economic recovery has indeed been slowest, but the indirect effects spread broadly throughout the economy. The President's budget calls for a further decline of five percent in defense spending during 1995.

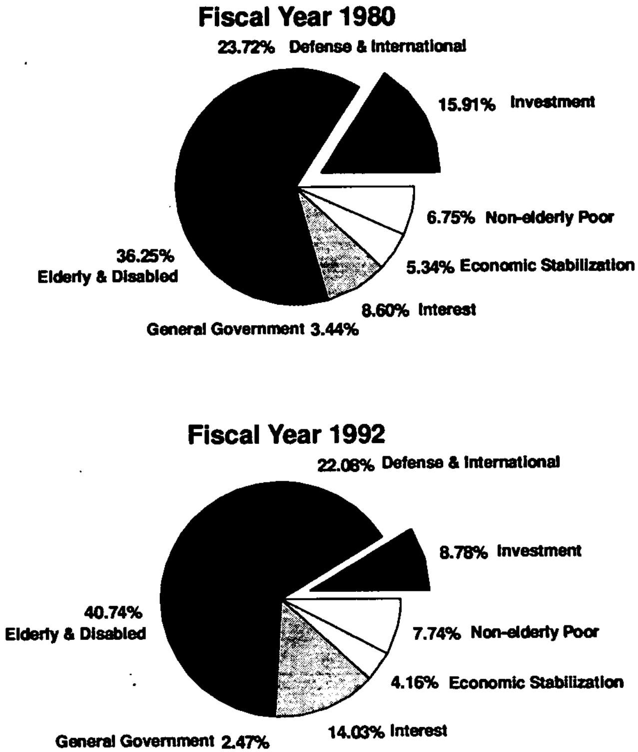
Nondefense federal purchases and state and local purchases supported by federal grants are rising slightly in real terms in FY94 but not enough to offset the defense declines.

The fact that nondefense federal purchases and grant-financed state and local spending are expected to rise at all is a reflection of the Administration's efforts to increase public sector investments in physical assets and human resources that will yield returns in the future. The decade of the 1980s saw a considerable decline in the share of the budget devoted to investment—whether investment in transportation infrastructure such as airports and roads, or environmental cleanup or nondefense research and development outlays to spur technological advances, or federal aid for education and training to strengthen the labor force (see Chart 23).

On the revenue side of the budget, CBO estimates an increase in total tax revenues from OBRA amounting to about two percent of total revenues for the year. It is reasonable to think that as much as half of the initial increase in tax liability for wealthier Americans (or about 45 percent of the FY94 rise in cash receipts from increased income tax rates) was anticipated by these tax payers in their behavior last year and exerted its fiscal restraint then. Nevertheless, the revenue side of the budget is exerting added restraint in 1994 as other provisions become effective and will exert some further, though lesser restraint, in FY95 as provisions are fully phased in.

CHART 23

Investment Fell During the 1980s
(Percent Distribution of Federal Outlays)



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

Deficit Reduction, Fiscal Restraint And Economic Growth

If the economy is absorbing the fiscal restraint from last year's deficit reduction act, why not move faster with deficit reduction? This question arises in many forms, including amendments considered in the recent debate on the budget, bills to cut spending by further lowering the caps on appropriations, or placing caps on mandatory spending.

There are a number of reasons to worry that more rapid increases in deficit reduction would hurt economic growth. First, a new round of budget cutting would occur in a very different financial setting from last year's initiative. The Federal Reserve has recently raised interest rates and financial markets appear to expect further increases. Perhaps the Fed would reverse course in the event of new fiscal restraint, bringing all rates lower, but such a response is highly uncertain. Even if it did occur, it might not be timed to offset the new fiscal restraint smoothly.

Second, private investment may not be able to make yet further gains from its already strong pace. Home building may reach demographic limits in the absence of public sector spending to assist lower-income families to enter the market, because real family income is not increasing significantly. Meanwhile, business investment depends not only on the interest cost of capital but also on sales and profits. Sales would be damped initially by further deficit reduction. At the same time, spending by lower- and middle-income consumers is still under some constraint from heavy debt and relative stagnant earnings.

So further sharp reductions in federal spending would increase contractionary pressures on the economy, at a time of rising interest rates. This could do substantial harm to economic growth and job creation.

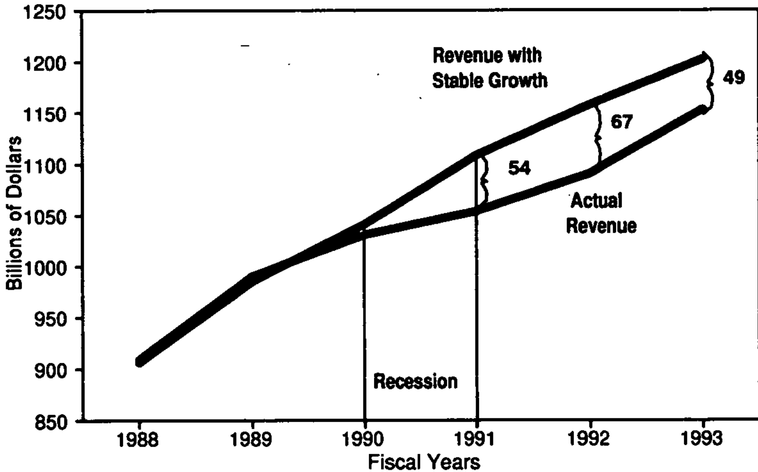
Overly rigid constraints on the budget could exacerbate the situation. If caution is not exercised, moving on a rigid path to a zero deficit by a fixed date, regardless of developments in the economy, could nullify the automatic "fiscal stabilizers" on a permanent basis. Even among analysts who question the usefulness of targeted counter-cyclical policy, there is a substantial consensus that the automatic stabilizers are necessary. They cushion the shocks that hit the economy from time to time,

keeping recessions from deepening into potential depressions.

The most important of these stabilizers is the loss of tax revenues that automatically occurs when the tax base is shrunk by layoffs, short work hours and lower profits. If it had been legally necessary to offset this revenue loss in the past recession, cumulative additional spending cuts or tax increases of $125 billion would have been necessary for the three ensuing fiscal years of 1991,'92 and '93, when the revenue short-falls were $54 billion, $67 billion and $49 billion, respectively (see Chart 24). This would have imposed further contraction on an economy already in recession, slowing growth and further cutting tax revenues in a vicious negative cycle.

The best fiscal policy prescription for now is to continue with the deficit reduction plan enacted last year without dramatic new cuts.

CHART 24



Source: Congressional Budget Office; Joint Economic Committee.

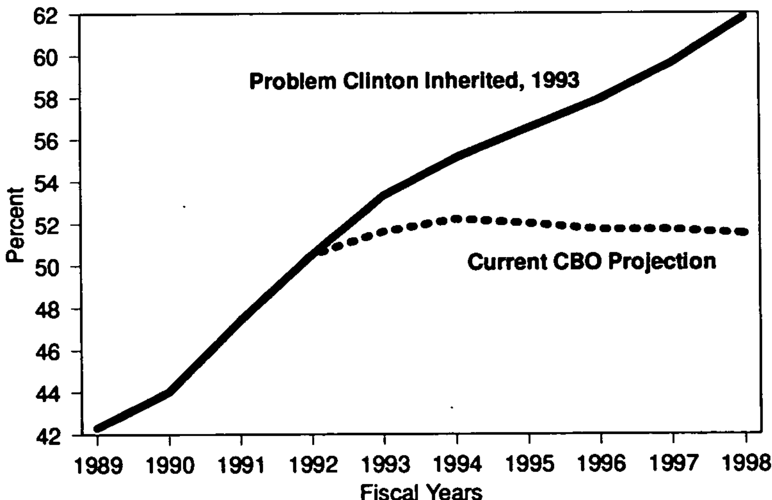
Congress should maintain the discipline put in place by OBRA 1993 and its amendments of the deficit reduction act of 1990. At the same time, there should not be attempts to achieve dramatic new deficit goals before addressing structural problems in the economy (see Chapter IV) and assessing their implications for the economy and the budget. With the federal debt-to-GDP ratio now under control, there is no need for hasty action (see Chart 25).

Policymakers should heed the recent testimony of Herbert Stein, the Chairman of President Nixon's Council of Economic Advisers:

> *... the federal debt is a small part of what we pass on to the future. We decide, mainly by our private saving, investment and research, what conditions for productivity and income we bequeath to our children and grandchildren. Also by public policy we are determining many of the conditions in which our descendants will live. If we leave our children a country free of the danger of war, with safe streets, reduced racial hostility, fewer miserable urban ghettos, and elevated culture, we will not have to apologize ...*

CHART 25 **Containing the Debt Explosion**

Debt Held by the Public as a Percent of GDP



Source: Congressional Budget Office, January 1993 and January 1994.

MONETARY POLICY

Monetary policy can significantly adjust the pace of economic growth, along with fiscal policy and the activities of private market participants. During the 1980s, after five years of economic growth and some signs of rising inflation, the Federal Reserve raised short-term rates available to banks by three full points, from 6¾ to 9¾ percent between late 1987 and March 1989. By the spring of 1989, the rate hikes were putting a damper on growth: the economy skidded to less than 2 percent growth for a year before hitting the ditch of recession. Real bank lending began a downward trend and industrial production and construction started to decline.

For almost five years prior to February 1994, interest rates had been falling, sometimes faster on the short end, sometimes on the long end. As Nobel Prize-winning economist Paul Samuelson testified before the Joint Economic Committee a year ago, the 1990-91 recession was deeper and the recovery more sluggish because the Federal Reserve acted "too little, too late" in lowering short-term interest rates.

In contrast to the preceding four years, interest rates were finally low enough to help propel the economy in 1993. The interest-sensitive sectors of the economy, such as housing, business investment, autos, and other durable goods, have been the sources of greatest economic strength over the last year.

But the Federal Reserve's February 4, March 22, and April 18 decisions to hike short-term interest rates have been followed by even more dramatic rises in both medium- and long-term rates. There can be no doubt that these higher rates will cause growth to be slower than would have occurred with continued lower rates.

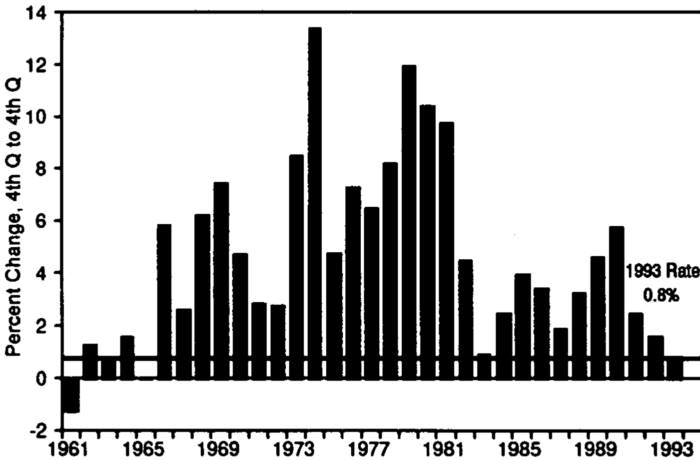
Are Increasing Interest Rates Justified?

There is little in the recent evidence on inflation to support the Fed's 75 basis-point hike in interest rates. The U.S. economy generated lower inflation in the last year than at any time in three decades. The only episodes since the mid-1960s with lower inflation in the general price indexes (consumer, producer, GDP) came with price controls in 1972 and the extraordinary oil price collapse of 1986.

Labor costs per unit of ouput—the dominant factor in total costs—are contributing to lower inflation. Hourly labor costs, including benefits like health insurance, are barely keeping pace with inflation. (Hourly wages alone have fallen in real terms.) Meanwhile, last year the nation enjoyed productivity gains of 1.9 percent. As a result, unit labor costs, grew at only a 0.8 percent pace (see Chart 26). With a two point gap between inflation and unit labor costs, labor costs are reinforcing the downward trend in inflation.

Proponents of higher interest rates have tried to find a serious inflation threat in the fact that prices of a few non-oil commodities have risen somewhat in the last few months. Acknowledging that non-oil commodity costs contribute a tiny share of the total spending in the broader price indices, they believe that commodity prices offer a clear insight into inflationary expectations.

CHART 26

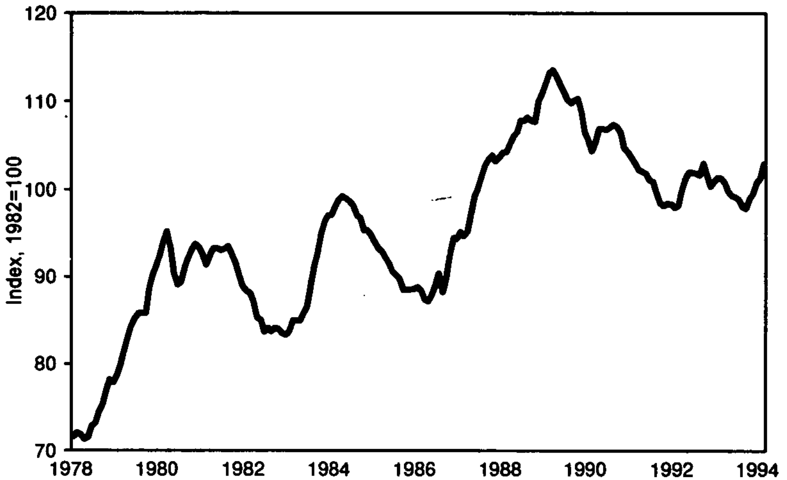


Sources: Department of Labor, Bureau of Labor Statistics; Joint Economic Committee.

However, commodity prices are notoriously volatile. They often rise for several months in a row only to fall back again, with no implications for the direction of the nation's broader inflation. Indeed, the rise in commodity prices over the last six months appears comparable to rises over a short period in 1991-92 that had absolutely no implications for general U.S. inflation in the year that followed (see Chart 27).

Moreover, the rise since last fall is much less than the commodity price surge that occurred during the recovery from the previous recession in 1983-84. That much larger rise did not prefigure a rise in general inflation in subsequent years.

CHART 27



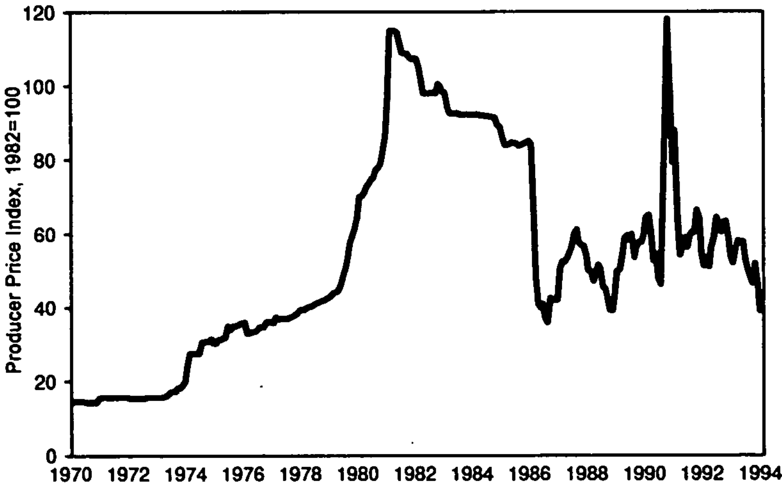
Source: Department of Commerce.

A full examination of commodity prices and general inflation must include oil. Oil represents a large component of spending; as for every other commodity, the trend in oil prices reflects some speculation about future inflation as well as supply and demand conditions peculiar only to that commodity. And, most importantly, every bout of inflation in the last two decades has been accompanied by rising oil prices.

Oil prices are, in fact, trending downward. Over the last year, falling oil prices have meant that general inflation has risen only 2.5 percent while inflation excluding energy has risen 2.8 percent. With continued strong output in the major oil producing countries and weak economic growth in most of the rest of the industrial world, oil prices are expected to remain moderate (see Chart 28).

Apart from keeping oil prices down, sluggish growth abroad puts other downward pressures on U.S. inflation. With soft markets at home, foreign producers compete more aggressively for sales in the U.S. market. In the last year, U.S. import prices for non-oil commodities have risen by an average of 1.8 percent.

CHART 28

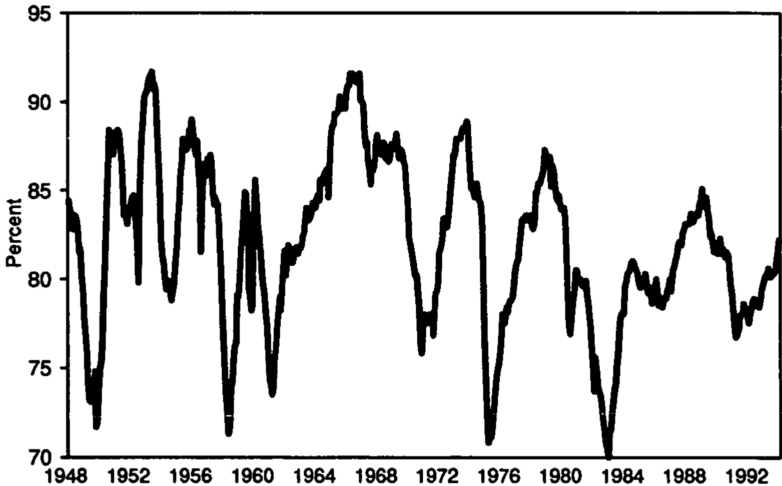


Source: Department of Labor, Bureau of Labor Statistics.

To justify higher interest rates, others have pointed to the rise in capacity utilization. Here again, the inflationary threat is more imagined than real. In February 1994, capacity utilization in manufacturing stood at 82.6 percent. This compares to peak rates of 88.9 percent in 1973, 87.3 percent in 1978, and 85.1 percent in 1989 (see Chart 29). In addition, some analysts believe that the official utilization numbers are overstated, because they do not reflect adequately recent strong investments in producer equipment.

Today's stiffer international competition also comes into play in evaluating the inflationary risk from tighter capacity utilization. Much more intense international competition means that, when an industry does reach capacity constraints, its ability to pass on price hikes is much reduced. In other words, the same level of capacity utilization in the domestic economy implies much less inflationary risk today than it did in the past.

CHART 29



Source: Federal Reserve Board.

Evaluating Monetary Policy

With fiscal policy on a pre-determined path apart from automatic cyclical developments, monetary policy has a particularly important role to play in achieving high employment and stable inflation and financial conditions. Clearly, the Federal Reserve operates under uncertainties and constraints in pursuing these objectives. For example, it can not directly control yields on long-term bonds, but it has a substantial influence on them through its direct control of short-term interest rates, as well as through its pronouncements and the timing of its actions.

International financial markets also exert a substantial influence on U.S. interest rates and financial developments generally. The sheer size of the United States economy, however, makes it able to influence interest rates in world capital markets.

Another major uncertainty under which the Federal Reserve operates is created by the rapid evolution of financial institutions and changes in the behavior of individual depositors, financial investors, and borrowers. Major changes in all of these financial aspects of the economy have demonstrated over the past 15 years that the Federal Reserve cannot manage and justify monetary policy through intermediate targets for aggregate measures of money supply, debt growth or liquidity. Each of these measures has varied dramatically in relation to either real GDP or GDP measured in current dollars at some time over the last decade and a half.

In any case, some analysts have always questioned the utility of these monetarist measures. They argue that attention to these intermediate and shifting measures has diverted attention from the more important question of monetary policy's impact on employment and economic growth.

Unfortunately, the Fed has not made public a detailed justification for its current operating procedures policy and how that policy relates to its ultimate targets for inflation, real growth and employment.

This issue is especially important in the remainder of this decade. Over the next five years, fiscal policy's effect on the economy will be restrictive to neutral and the ratio of debt to GDP will have stopped rising for the first time in two decades. As a consequence, if growth is to be sustained,

monetary policy will need to be flexible and responsive to conditions in the real economy.

At the current juncture, the challenge is to encourage economic growth. Of course, stability of inflation yields real benefits. It makes it possible for those entering long-term contracts, whether wage contracts or investments, to know the purchasing power of their returns. And it makes movements of individual prices more reliable indicators of surpluses or shortages of supply.

But with current rates of inflation still very low, achieving still lower inflation measured on some mechanical index seems unlikely to yield noticeable gains in economic efficiency and real incomes. To pursue such a goal may be a serious mistake because of the potential cost in lost jobs and output and high unemployment.

TRADE ISSUES

For more than two decades, the U.S. has been expanding its international economic activity faster than the domestic economy has been growing. Since 1970, exports of goods and services have climbed from 5.6 percent of GDP to 10.4 percent, while the ratio of imports to GDP has soared from 5.5 percent to 11.4 percent (see Chart 30).

CHART 30

The tighter integration of the U.S. economy with that of the rest of the world has had positive and negative effects on Americans. Not only do American consumers gain from lower prices and a wider variety of products, but there are dynamic gains to the economy as well. These include greater competition leading to more innovation, the achievement of scale economies because of larger markets, and improved technology—embedded both in new products and in production processes. Finally, the increased competitive threat from imports holds U.S. inflation in check because U.S. producers no longer have the market power to raise prices as U.S. capacity tightens.

On the negative side, trade often is cited as one factor that has exerted downward pressure on the income of workers at the bottom and middle of the U.S. wage scale. Simultaneous with the two decade boom in U.S. imports, there has been a drastic decline in wages for workers at the bottom of the wage scale and stagnation of wages of those in the middle. Some have speculated that trends in technology could have a similar negative effect on the bottom and middle of the wage scale as trade. Because the two trends, trade and technology, are closely intertwined, the separate magnitude of each of these trends on wages cannot be measured.

Several studies have concluded that trade has had only a modest effect on wages compared with technology. They have measured trade by the employment-displacing effects of higher imports, and they have measured technology by the change, within industries operating in the U.S., in the proportions of workers according to their levels of education. They find that the adverse effects of within-industry education mix is greater than the import displacement effect.

Trade pressure may contribute, however, to much of what these studies identify as a domestic "technology" effect. For example, trade pressure may induce U.S. producers to develop technologies that require fewer workers with less schooling. In addition, trade competition may also lead U.S. multinational companies to move offshore those operations that use more workers with less schooling. To the extent that either of these pressures are at work, the change in industry employment by education level would not reflect developments in technology independent of trade.

Rather than try to distinguish the effects of trade and technology on wages in a single country, one recent study compared changes in trade and wages internationally. For each country, it gauged the change in wage polarization and the change in import penetration from lower wage countries. It found a remarkable correlation: those countries with the largest gains in import penetration from lower wage countries had the greatest increase in the gap between wages at the top and bottom of the wage scale. Of the countries studied, the United States had both the largest increases in import penetration and in wage dispersion.

Concerns about the effects of competition with low-wage countries fueled much of the controversy over the North American Free Trade Agreement (NAFTA) last year. Many opponents of NAFTA believed that the agreement, as structured, would have a sizable negative effect on earnings of many American workers. NAFTA supporters countered that the effects would be generally positive and that any negative effects could be remedied.

The United States can help U.S. firms and workers compete with foreign producers and adjust to the inevitable dislocations that will occur for some. Too many young American workers finish their education without the skills necessary to compete in the modern world economy. Our major competitors in Europe and Japan generally provide their new entrants into the work force with a higher level of skills learned in the class room or in training and apprenticeship. In addition, as market conditions and technologies change, firms should be encouraged to retrain their existing work force instead of replacing their existing work force with workers educated or trained by others.

IV

LONG-TERM STRUCTURAL CHALLENGES

Even if the cyclical recovery stays on track, several structural challenges threaten the long-term future of the economy. Principal among these is the continuing crisis in health care. A second major challenge is restoring public investment at a time of tight budgets. And finally, economic policy must concentrate on restoring real income growth for the American people, especially those without a college education.

HEALTH CARE REFORM

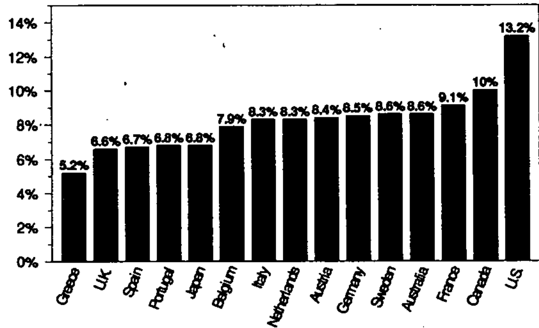
The most immediate structural economic problem that needs to be addressed through government action is the crisis in the nation's health care system. The current health insurance system, which is fragmented and cross-subsidized in complex ways, is not an efficient way to provide health care to all Americans and leaves far too many Americans deprived of decent care. Inefficiencies in the system and inequities in the ways that it is funded create distortions in labor markets and reduce workers' standard of living, all while maintaining high and rising health care costs. Without comprehensive reform, the economic distortions inherent in the present system will continue to depress the rate of growth of the American economy, and will lower standards of living for American workers and their families.

Major Economic Problems With The Current Health-Care System

Health-care spending in the United States is high and rising rapidly. One dollar out of every seven spent by Americans in 1993 was spent on health care—14.3 percent of U.S. gross domestic product (GDP) compared to an average of less than 9 percent of GDP among other industrialized nations (see Chart 31). Health-care costs have increased at twice the rate of income growth and, without reform, are projected to consume nearly 19 percent of national income by the year 2000 (see Chart 32).

CHART 31

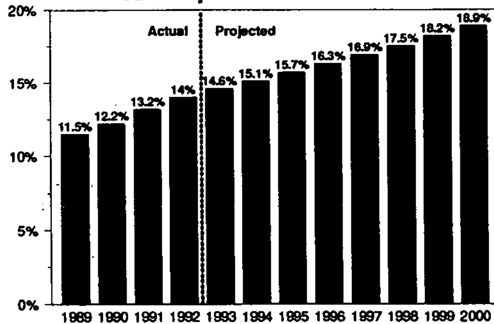
Percentage of GDP Spent on Health Care in 1991



Sources: OECD, 1993; Joint Economic Committee.

CHART 32

Total Health Expenditures as a Percent of GDP
CBO Projections for 1993-2000



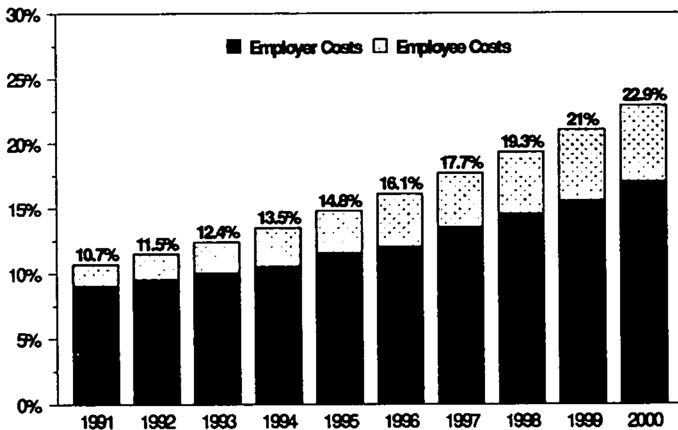
Sources: Congressional Budget Office; Joint Economic Committee.

High and rising health care costs in general have translated into high and rising insurance premiums for firms that provide health care coverage to their employees. For those firms that provide benefits, the cost of coverage per employee has more than doubled since 1987 to $3968 in 1992. Overall, health insurance premiums as a percentage of business payrolls have been rising even faster than health spending generally (see Chart 33). Employer-paid health costs per full time employee doubled between 1985 and 1992. On average, business costs for all forms of health care coverage grew by 8.5 percent during the 1980s after adjusting for inflation, compared to a 4.4 percent real rate of increase for U.S. health costs generally and a 3.2 percent rate for the other G-7 industrial nations.

Ultimately, it is American workers who are harmed most by rapidly rising health care costs. Most studies find that between 80 and 100 percent of business health insurance spending is ultimately paid for by workers through reduced wages (or slower wage growth). The *Economic Report of the President* notes that if business spending on health insurance were the same share of total compensation today as in 1975, average annual wages per employee could be as much as $1000 higher than they are now.

CHART 33

Health Insurance Premiums as a Percent of Payroll are Rising



Sources: Johns Hopkins University, 1992; Joint Economic Committee.

Labor Market Distortions

Lower wage growth is not the only problem caused by the current health insurance system, however. The system also distorts labor markets and provides incentives for behavior that may prove costly to society in the long run. For example, firms that provide health insurance end up subsidizing health care for the uninsured and under-insured employees of many other companies. Some employers have an incentive to seek a cost advantage over competitors by not offering health insurance to their work force. Practices such as hiring more contingent workers, leasing employees, contracting out, and relocating jobs outside the United States and other means has become common in some industries.

In addition, firms known for providing good health coverage tend to attract and retain workers who value it more highly, such as older workers and those with expensive medical conditions. This causes even the most efficient firm to accumulate potential costs the longer it stays in business, particularly if it also covers retirees.

Large disparities in employer-paid health coverage also reduce labor market mobility by trapping workers with pre-existing conditions in jobs they might otherwise leave. A 1991 *New York Times/ CBS News* poll found that 3 in 10 middle-income workers said they were staying in jobs they wanted to leave only because of a need to keep their company health coverage. Estimates from other sources are lower, but it is clear that a significant number of American workers are unable to change jobs when they would like to for reasons relating to their health insurance coverage.

Finally, running separate health insurance plans for different companies is not always administratively efficient, particularly for small and medium sized firms. These firms tend to experience higher costs per insured worker than do larger companies. If small and medium sized workforces were pooled and administered as large groups, their premiums would be less volatile and would probably also be lower on average.

Under the current system of health insurance, business costs vary from virtually zero for some firms to 20 percent or more of payroll for others, putting firms that cover their workers at a competitive disadvantage. The economic thrust of health care reform should be to level the playing field

between firms, reducing the shifting of costs onto other firms or the government.

The Need To Improve Health Care Coverage

Although the United States spends a high share of total income on health care, we provide coverage to a much smaller proportion of the total population than is typical for other industrialized countries. About 38 million Americans were uninsured at any given time in 1992, the most recent year for which estimates are available, and about 58 million were uninsured for at least some part of the year. Most of those who were uninsured simply could not afford coverage. Most working Americans receive some health insurance through their employers, but coverage is lacking for many lower-paid workers, the jobless, and members of their families.

Further, insurance companies limit policies for people who have higher than average medical risks, and who are therefore likely to cost insurers more. As a result, even those who have health insurance may lack essential coverage for major medical problems, while others will pay very high premiums because they—or other members of their insurance group—have had health problems in the past.

Even those who have access to health insurance are adversely affected by the unevenness in health care coverage, which results in fewer preventive services and higher medical care costs. The uninsured often use relatively expensive forms of medical care, such as emergency room services. The costs of providing these services are paid by hospitals and other providers, who in turn pass these costs on to insured patients through higher prices. Ultimately, this "cost-shifting" causes insurance premiums to rise.

Inadequate insurance coverage, in other words, not only exposes individuals to unacceptable risks, but also causes distortions and inefficiencies that hurt our economy. Workers and their employers face higher insurance premiums and higher medical bills, while federal, state and local governments find themselves devoting increasing shares of their budgets to health care spending. As we spend an ever-greater share of our national income on health care, less and less is left to meet other priorities. And although the quality of health care services received by those with adequate insurance is high,

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large numbers of people still lack access to adequate care.

This may be one factor in explaining why we still lag behind other industrialized countries in such indicators of overall national health such as infant mortality and life expectancy. As the *Economic Report of the President* puts it, "The United States faces a health care crisis that demands a solution, both for the health of its citizens and the health of its economy." We will not see a solution to either problem—inadequate coverage or rising health care costs—without comprehensive health reform.

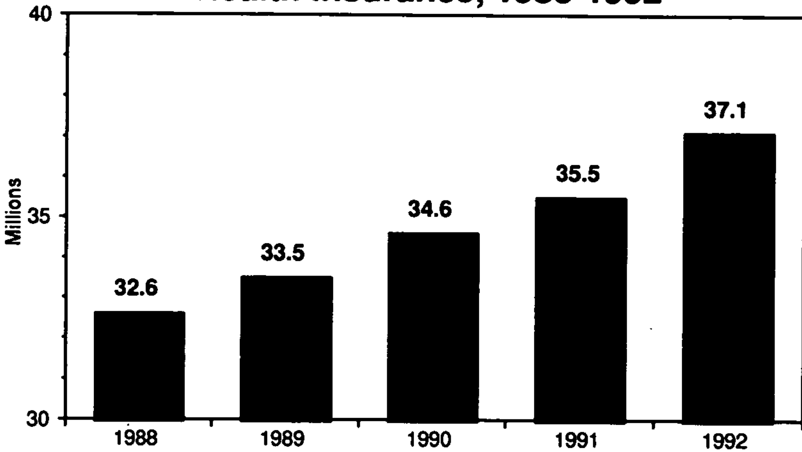
Issues And Problems In Reforming The American Health System

Inadequate health care coverage and rising health care costs are the two issues that motivate most health reform proposals. Ultimately, the economic problems associated with the need for health care reform largely result from these two issues. In order to solve these problems, reform proposals must address two important related issues as well: the distribution of health care costs—how premiums will be set for different types of people and who will pay those premiums—and how to finance the costs of coverage, particularly for those who cannot pay.

The need for coverage

About 17 percent of the population under age 65 lacked health insurance at any given time during 1992, the most recent year for which data are now available. (Almost all Americans aged 65 and over are covered under Medicare.) An even larger share—more than one-fourth of the under-65 population—were uninsured for at least part of the year. Further, the number of uninsured has been rising steadily over the past several years, as Chart 34 demonstrates.

CHART 34



Source: The Urban Institute analysis of 1993 Current Population Survey.

Being unable to afford health insurance is the major reason why people are uninsured. According to a recent Kaiser Family Foundation poll, almost 60 percent of uninsured adults said that they could not afford coverage. Others lack coverage for specific illnesses or conditions because the costs of such coverage would be prohibitive under current insurance practices. Under the current system, those with pre-existing medical problems are generally excluded from lower cost group health plans, and can often obtain only partial insurance.

Lack of health insurance coverage is a serious problem for many Americans, and fear of losing coverage may keep people from changing jobs or starting new businesses. Because welfare recipients automatically receive eligibility for health care through Medicaid, the fear of losing this coverage may keep some people on welfare for longer than they otherwise would be. Low income families and those who work for small firms are particularly likely to lack insurance. Providing guaranteed health care for all Americans would provide greater employment mobility for those who cannot afford to change jobs or leave welfare under today's health insurance system.

Coverage for all Americans also would improve the quality of care for those now without insurance, and would provide that care more efficiently. Today's uninsured do receive some care, although that care often comes only when medical problems have become acute and more expensive to treat. Most emergency rooms and many hospitals do provide emergency care to uninsured patients, even if they cannot pay. The costs of this charity care ultimately are passed on to other hospital users through higher costs. These higher costs cause insurance companies to raise premiums, resulting in higher payments for all of those who have health insurance.

In many cases, earlier doctor visits and more preventive care could have averted the acute medical problem, but those without insurance are much less likely than other people to visit a doctor in the first place. A recent survey found that 71 percent of Americans without insurance reported postponing needed care for financial reasons, and 34 percent went without needed care altogether. Without regular access to a doctor, people often end up in the emergency room—an expensive place to be treated—for problems that could be handled much more routinely.

Distributing health care costs more fairly

The need for fairer health care cost sharing and greater portability of coverage from job to job is widely recognized. Under the current insurance system, those with existing health problems are particularly likely to have problems finding affordable insurance, and in many cases may not be able to find coverage at all if they change jobs. Without some form of comprehensive health care reform, however, major improvement in private-insurance markets will be hard to achieve.

Those who are more likely to have health problems, or who are already ill, are disproportionately likely to participate in more generous insurance plans, causing the costs of those plans to rise. Understandably, if insurance companies are not required to serve all potential participants, they are likely to try to exclude those with higher costs so that they can keep premiums low and attract as many healthy participants as possible, thus maintaining greater profitability. And if people are charged premiums based solely on their own probable health care costs, many people who are already ill will find health insurance unaffordable.

On the other hand, the young and healthy are less likely to participate in any health insurance plan at all, gambling instead that if they have major health problems they will receive charity care. The non-participation of these lower-cost patients causes average costs per covered patient to rise. Further, any care these people do receive will have to be paid for out of premiums collected from other participants. Because some patients are not paying any premiums, premiums for everyone else are higher than they would have to be if everyone participated in the insurance system.

Unfortunately, some of today's healthy people become tomorrow's sick people. An insurance system that places major financial burdens on those who become ill is likely to affect most people adversely over the course of their lifetimes. So assuring people health care coverage at affordable prices even if they do become sick is an important priority.

Controlling the growth of health care costs

Americans already spend a much higher share of their incomes on health care than do people in other major industrialized countries. In spite of this, life expectancies in the United States are lower than in many other countries, and also lower than would be predicted based on our relatively high national incomes. These facts suggest that our health care system may be relatively inefficient in the way that it provides care.

In the current system, there is little incentive—and in many cases, little ability—for consumers to limit health care spending. In the long run, unnecessary use results in higher premiums for everyone, but in the short run may have little or no effect on the consumer's own health care spending, which is mostly paid for through insurance. Requiring co-payments or deductibles from the consumer may increase incentives to limit care, but if these payments are too high they can become barriers to necessary and appropriate care.

Further, much health care spending is decided upon under circumstances where the consumer has very little control over the decision—for example, in emergency situations. Often, the consumer lacks the knowledge to evaluate the need for and cost of the services to be provided. And while consumers may choose their doctors or their health care plans, few consumers directly choose which hospital they will use. Finally, many consumers do not have a

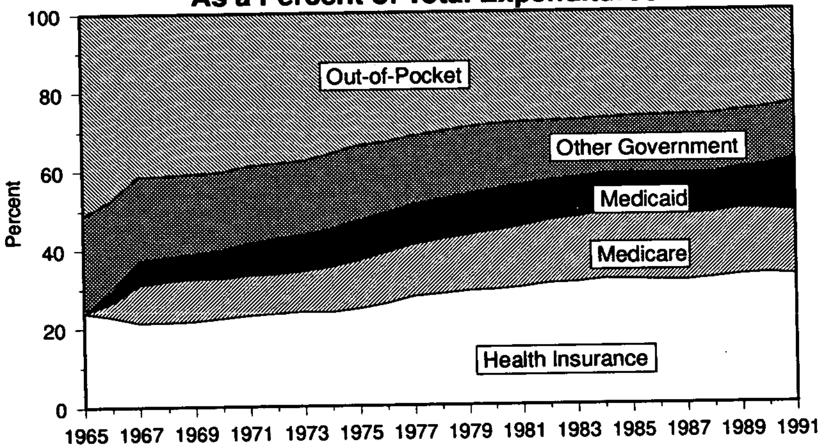
choice of health care plans—only about half of all workers with employment-related health insurance coverage have a choice of more than one plan.

These limitations on choice in health care consumption, combined with the incentives for over-consumption, are the factors that make current health care markets uncompetitive. As a result, markets alone may not be able to rein in rising health care costs.

Financing Health Care

Health care is paid for under our current system in three major ways: through private insurance, through government programs such as Medicare and Medicaid, and through out-of-pocket expenditures by consumers. Government currently accounts for almost half of total health spending, as Chart 35 shows. Most of this spending comes through Medicare and Medicaid, and most of it pays for care for the elderly, the disabled, and some low-income families. Other government spending on health, which includes coverage of government employees, has been shrinking steadily as a share of total spending.

CHART 35



Sources: Council of Economic Advisers; Health Care Financing Administration.

Private insurance pays for about 30 percent of total health spending, while the remaining 20 percent is paid directly by consumers. About three-fourths of private insurance spending is paid for by employers, while about one-fourth comes directly from the households covered by the insurance. And as noted earlier, even the employer costs may ultimately be passed on to workers, through lower wage increases than would otherwise occur. According to the *Economic Report of the President*, if business spending on health insurance were the same share of total compensation today as in 1975, average wages per employee could be as much as $1,000 higher than they are now.

For most employers—those who already provide coverage—assuring workplace coverage would not represent much of a change, although health care reform as a whole might well reduce their insurance costs. Many companies will see substantial savings if insurance companies are no longer allowed to charge higher rates on the basis of health status, for example. Extending coverage to the entire population should ultimately reduce average costs as well, particularly for those companies that already pay higher-than-average insurance premiums.

Some have opposed efforts to assure workplace health coverage. A recent Congressional Budget Office study of this issue, however, suggests that any effects from such efforts would be minimal.

Although there are disputes about the short-term impact of different health-reform proposals on the federal deficit, there is general agreement that reform will help reduce the long-term deficit. As Robert Reischauer, Director of CBO, stated in his testimony before the Finance Committee on the Administration's initial proposal, "CBO believes that the proposal holds the promise of reducing the deficit in the long term."

In some sense, however, it is not the impact on the federal budget that is most important, but rather the effects of the proposed reforms on national health expenditures and on the economy as a whole. After all, most of the proposed workplace-based coverage and related financing would simply replace payments that employers are currently making. For example, CBO projects that under the Administration's proposal, national health expendi-

tures as a whole would fall by $30 billion relative to the current system by the year 2000, and by $150 billion by 2004.

Conclusion

In the end, any potential problems with reform must be balanced against the harm that will be done if the current system continues unchanged. As Dr. Marilyn Moon testified in hearings on health care held by the JEC in September 1993, "If there is no national reform, many of the problems that are helping to spur change will likely worsen, and the patchwork response of our health care system will leave increasing gaps in protection for families."

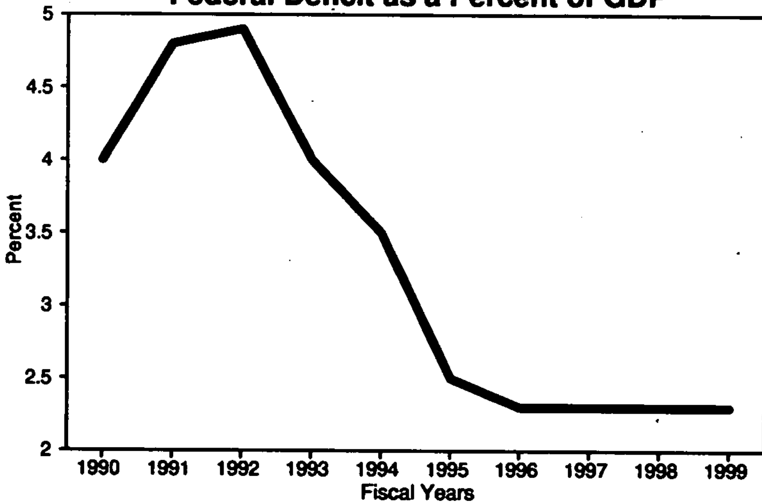
Under the current system, neither private insurers nor the government has an effective way to limit the growth in total health care spending, and health expenditures continue to rise. Government attempts to control its own spending—for example, by limiting reimbursements to health care providers under Medicare and Medicaid—may even cause spending to rise faster in the private sector, as some costs for Medicare and Medicaid patients are shifted onto private insurance companies instead. Even while costs rise, the number of people who are uninsured also rises, and some of those with insurance nevertheless lack adequate access to care. Both to control rising health care costs and to ensure access to health care for all Americans, comprehensive reform of our health insurance system is needed now.

FISCAL POLICY AND PUBLIC INVESTMENT

Challenges For Fiscal Policy

A second major structural challenge is increasing necessary public investment at a time of tight budgets. The current federal budget plan imposes stringency through most of the remainder of this decade. By doing so, it lowers the deficit relative to GDP to the 2¼ to 2½ percent range (see Chart 36) and keeps the ratio of federal debt to GDP essentially flat. In that financial sense, it is a sustainable budget policy. There is a serious public commitment to maintaining this discipline and the President and the Congress can be expected to honor this obligation.

CHART 36

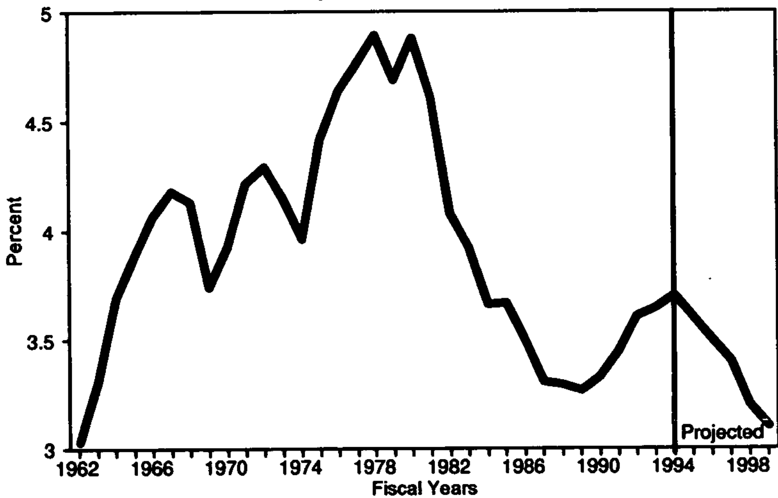


Source: Congressional Budget Office, January 1994.

Yet it poses serious challenges. Limitations on discretionary spending are very tight. By the end of the five-year budget planning period, domestic discretionary spending is expected to be at the lowest level relative to GDP since the early 1960s (see Chart 37). And international comparisons show that the United States has the lowest ratio of total capital investment to GDP of any of the major OECD countries and that the public sector component of this total is also the smallest of any of these countries (see Chart 38).

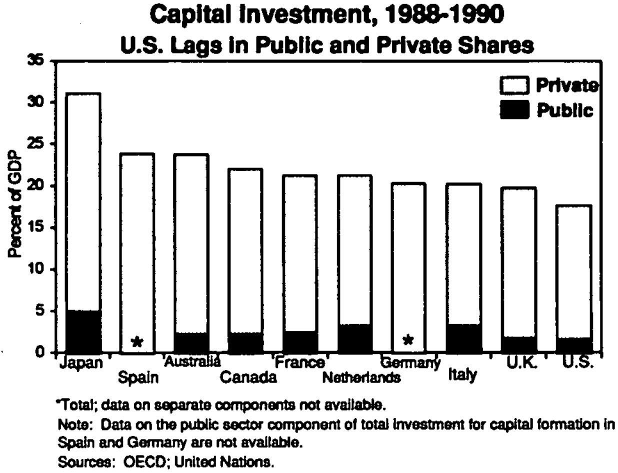
Meanwhile, although both taxes and outlays from non-health entitlement programs are expected to remain about constant relative to GDP, outlays of the major health entitlements under current law are expected to rise by 1.2 percent of GDP over the next five years, in the absence of comprehensive health care form (see Chart 39). Under these circumstances, achievement of further major deficit reduction relative to GDP becomes extremely difficult.

CHART 37



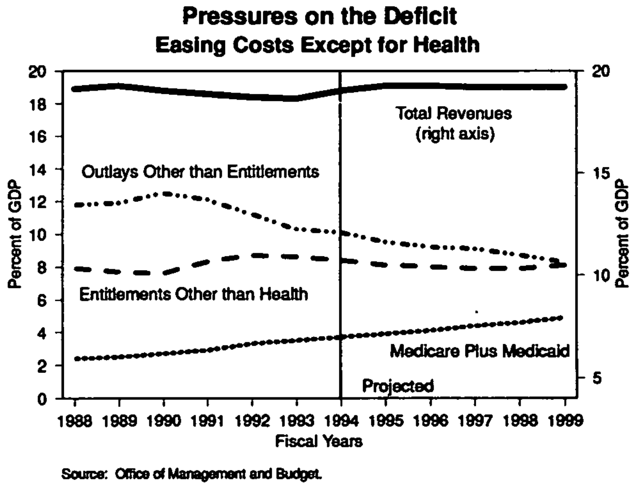
Source: Office of Management and Budget.

CHART 38



*Total; data on separate components not available.
Note: Data on the public sector component of total investment for capital formation in Spain and Germany are not available.
Sources: OECD; United Nations.

CHART 39



Source: Office of Management and Budget.

There are no quick fixes to achieve sharper deficit reduction, or to free up resources for investment. For example, it seems unlikely that substantial funds can be generated quickly through cutting entitlement spending. For FY95, just over 60 percent of gross entitlement outlays (excluding deposit insurance) are for Social Security and Medicare. Although health reform will have a major bearing on Medicare costs, both programs involve long-standing commitments to beneficiaries, which cannot fairly be changed without some advance notice. Over the long term, the appropriate levels of spending and the financing of entitlement programs requires review. But cutting entitlement spending by itself offers no panacea.

Fiscal policy is also constrained by the commitment to deficit reduction over the next five years, which has seriously constrained proactive use of the budget as a counter-cyclical stabilizer. But there is no seriously accepted argument against automatic stabilizers. It is widely accepted that they can and should continue to play an important part in economic policy. Most of this role is performed on the revenue side of the budget, as taxes fall off when the tax base grows less rapidly or declines.

A smaller role, but one that has been important for many regions and industrial sectors in past recessions, is played by unemployment compensation.

When the economy turns down in a general recession, neither individual employers nor employees are at fault. Firms cannot be expected to continue to pay workers when sales decline and there is no work to be done. Nor are workers at fault when a firm no longer has jobs for them to do.

Too little spending and sales leads firms to lay off workers. Their cuts in spending lead to further declines in the economy's sales and production and still further layoffs. The role of unemployment insurance is to weaken this vicious cycle by paying a fraction of the previous wage to experienced workers for a limited period of time, so long as they meet the requirement of actively searching for work.

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, also has 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 economic policy of 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.

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.

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 no investment 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.

Federal outlays for physical capital as a share of GDP have slumped badly since the 1970s. It probably is easier to postpone investments in physical assets like roads, bridges and waterways than to terminate ongoing operational programs. It is easier still not to make new investments based on new opportunities or technologies, the absence of whose benefits may not be noticed because of their diffuse nature.

The pressing need for public investment in an era of tight budgets argues for a careful review of budget accounting practices so as to determine whether they instill a bias against capital investments. Such investments may be short changed because large "lumpy" commitments can seem postponable and are more readily cut. To the extent that this is the case, more balanced decisions might be made using a capital budget accounting framework in which annual depreciation rather than the entire cost of a capital project is charged to the operating budget, in the same way that most states and all private businesses do now.

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, but also 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 over 3.5 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 decline. 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 under the Reagan and Bush Administrations. 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 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.

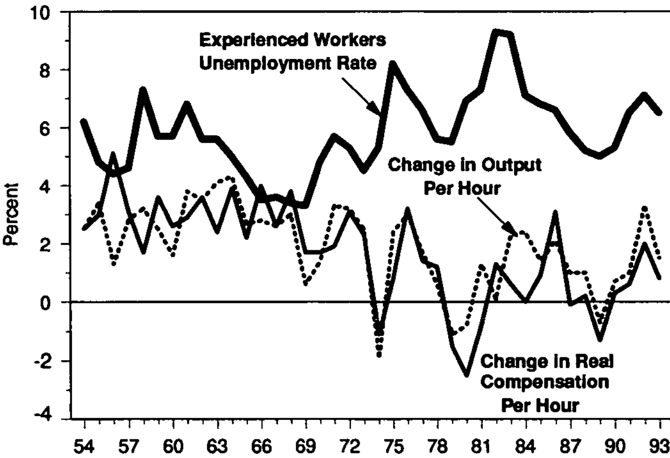
STAGNANT INCOMES AND INEQUALITY

Reduced Growth And Increased Inequality

Perhaps the most formidable challenge facing economic policy is reversing the long-term decline in real earnings and attendant rise of inequality that has plagued the economy since the mid-1970s. For many Americans, the labor market is not functioning adequately. Earnings growth has been stagnant for most of those who have jobs, and real incomes have declined for people in all but the uppermost parts of the income distribution. The two decades from 1954 to 1973 were ones of generally low unemployment, rising real wages and satisfactory rates of productivity growth. Unemployment was above six percent in only three of these years, and real compensation per worker grew by 2 to 4 percent per year.

The contrast to the most recent two decades is striking. Unemployment has been below six percent in just seven of those years, while the rate of growth in real compensation per worker has been above two percent in just two of them (see Chart 40).

CHART 40

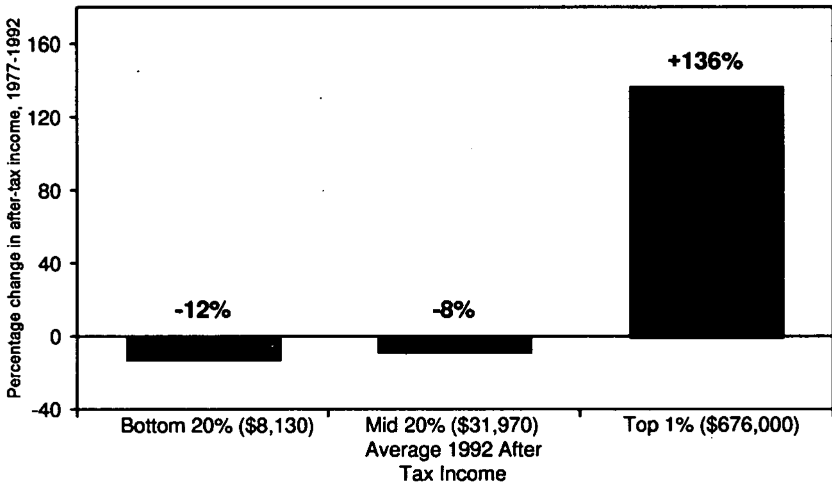


Source: Economic Report of the President 1994, Council of Economic Advisers.

Increased inequality of earnings and income has been documented in a variety of statistics and studies, and has assumed greater political and policy significance in recent years. As Chart 41 shows, middle-class incomes declined during the 1980s, while the income of the top one percent skyrocketed.

A distinguishing feature of the 1980s was the growing inequality in earned income between workers with a college education and everyone else. Wage and earnings inequality also grew between younger and older workers, between those living in rural and urban areas, and between minority groups and the majority white population. Importantly, inequality has also increased within these and other groups.

CHART 41



Source: Joint Economic Committee.

There is considerable agreement about the structural and institutional factors involved in rising inequality.

> *The U.S. creates lots of jobs. But by weakening unions and failing to adjust the minimum wage for inflation, it has allowed the wages of those at the bottom to fall. The result is companies that are more globally competitive, but also a widening gap between rich and poor and an uncomfortably large number of workers...living in poverty.*
>
> David Wessel and Daniel Benjamin, *Wall Street Journal*

> *Underlying the enormous disparities in the fortunes of American families in the 1980s was a rise in labor market inequality that shifted wage and employment opportunities in favor of the more-educated and more-skilled. Less-educated men, in particular, suffered substantial losses in real earnings and in the likelihood that they would hold a job at any point in time.*
>
> Richard Freeman, Harvard University and Lawrence Katz, U.S. Department of Labor

Family income was stagnant throughout the 1980s and into the 1990s. Real family income would have declined were it not for a dramatic increase in the number of women in the paid work force. Since most families rely primarily on wages for their income (rather than interest, dividends, rent or government cash assistance), any analysis of stagnant income must focus on wages and specifically on the profound changes in U.S. wage structure over the past decade.

Growth Of Low Wage Work And The Working Poor

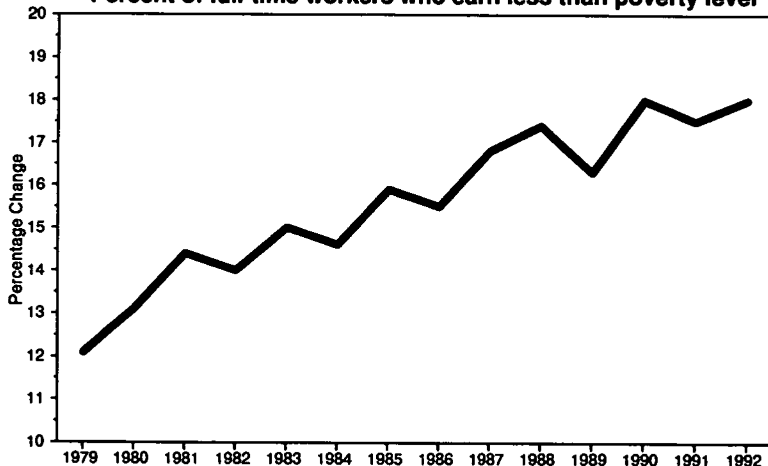
Along with the erosion in earnings power in the majority of the work force has come a much greater share of workers earning low wages.

A recent Census Bureau report showed that the percentage of Americans working full-time but earning less than a poverty level wage has risen about 50 percent in the past 13 years. The Census Bureau found that 18 percent of the nation's full-time workers earned less than a poverty level wage in 1992, compared to 12 percent in 1979. The trend is shown in Chart 42.

The picture is worse for young workers. The percentage of full-time workers age 18 to 24 with below poverty level wages more than doubled from 23 percent in 1979 to 47 percent in 1992. The Census Bureau described this development as "astounding."

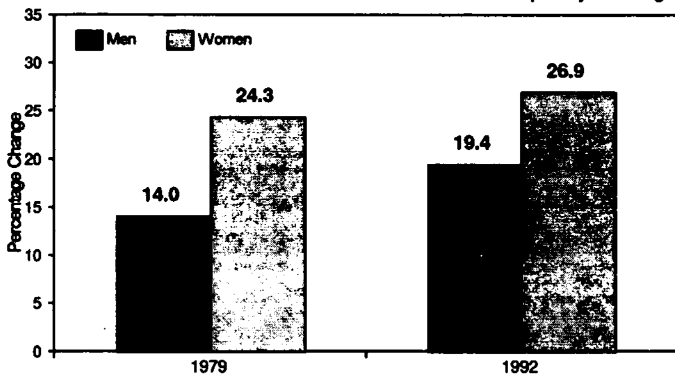
The incidence of low-wage work has grown faster for all groups, but women are still more likely to work for below poverty wages. Significant increases in low-wage work have occurred among African-Americans and Hispanics, as Charts 43 and 44 show.

CHART 42



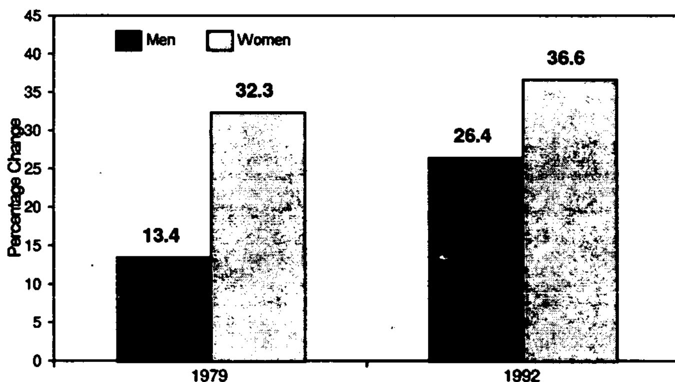
Source: Department of Commerce, Bureau of the Census.

CHART 43



Source: Department of Commerce, Bureau of the Census.

CHART 44



Source: Department of Commerce, Bureau of the Census.

Nearly one-half of all younger (18-24 years old) workers do not generate an income that can keep a family out of poverty, and neither can one in five workers between the ages of 25 and 34.

Today, just over one in ten white male employees work at less than poverty level wages, while the same is true of more than one-fourth of all Hispanic males (26.4 percent), and nearly one-fifth (19.4 percent) of all African American males.

But the largest increase in the incidence of low earnings occurred among workers without high school degrees. In 1979, 15 percent of men without high school degrees worked for jobs paying low earnings. Today that figure has risen to 32.2 percent, meaning that nearly one-third of all men without high school degrees working full time cannot earn enough to keep a family out of poverty.

Downward Pressure On Wages

This growth of low earnings is a function of continuing downward pressure on wages. In their study of recent wage trends, economists Gary Burtless and Lawrence Mishel reported that the wages of noncollege educated workers have been "beaten down," but there has been very little "bidding up" of wages of college educated workers, which increased by only 1.8 percent between 1979-89 and declined 1.5 percent between 1989-91.

Such statistics dramatize the powerful downward pressure on wages that have prevailed for many years across most of the labor market, with only the highest earners showing substantial gains.

A combination of factors has been at work to drive down wages. Many of them, such as the intensified competition from trade, declining unions, and shifts in employment demand among industries, are intertwined and impossible to isolate and weigh separately.

The size and composition of the U.S. work force has been affected by the entry of the baby boom generation in the late 1960s and continuing through the early 1980s, the unprecedented rise in paid employment among women, and increased immigration. But, according to Burtless and Mishel, these demographic factors at best only partly explain the decline in real wages and the rise of low-wage work during the 1979-89 period.

The deterioration in real earnings experienced by U.S. workers since 1973 is only partly a story about a shift from a goods producing to a services based economy, with a loss of high-wage manufacturing jobs held by workers with high school degrees or less. The declining percentage of workers represented by unions in the private sector has made it easier for real wage reductions to be implemented. The minimum wage was kept at the same nominal value for most of the 1980s, and even with its recent step increases it represents a smaller fraction of average hourly earnings than it did in the 1950s and 1960s. An increasing part of compensation increases have gone to pay for the rising costs of health insurance, as discussed elsewhere in this report.

These trends are especially pronounced in the labor market experience of minorities, and especially minority youth, in the U.S. work force. Unemployment rates and nonparticipation rates among African-American and Hispanic workers rose during the 1970s and increased even further during the 1980s. A study using twenty-five years of cross-section data from the Current Population Survey, found increased inequality during the 1980s and noted that inequality worsened for African-American and Hispanic families to an even greater degree than for white families.

Wage inequalities between minority and white workers are not altogether explained by differences in educational achievements. While workers with 12 years of education or less saw their real earnings fall over the decade, on average, the wages of minority workers in this category fell more than those of non-minority workers. Even though the average real earnings of the best educated professionals rose during the 1980s, those of minority professional workers rose less than those of non-minorities.

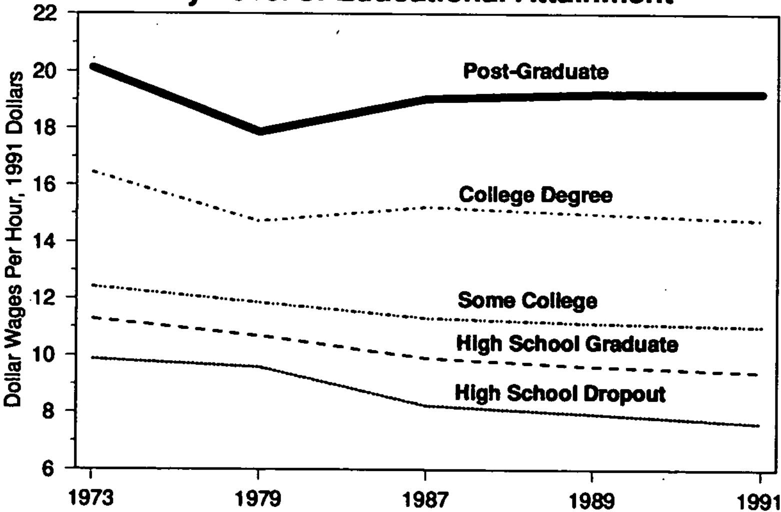
The lowest earning 80 percent of the nation's white families experienced a shrinkage in their relative incomes between 1980 and 1992. Declines were even steeper for African-Americans and Hispanics, with only the top quintile of black families showing a gain in income relative to the all-family average. Within each group, the position of the lowest three-fifths of families deteriorated compared to the highest two fifths. The largest adverse change was a drop of 25 percent in the real mean income of the lowest 20 percent of African-Americans, from $5,685 in 1980 to $4,255 in 1992 (in 1992 dollars).

Investing In Human Capital

All of these problems underscore the need for increased public investment in education and training. Although education and training alone will not solve these problems, there can be no comprehensive solution without greater investment in human capital. For while there is no convincing evidence that recent high school graduates are less well academically trained that their predecessors, there is clear evidence that the long-term "payoffs" to education, and especially to math and language skills have increased. (See Chart 45).

These dividends to "higher" learning skills are not collected, however, until graduates are well into their 20s, with the highest payoffs coming to those with a four-year college education. Those workers with higher math and reasoning skills were better positioned to accommodate the revolutionizing effects of technological change or the business reorganization needed to respond to competition. Those whose skills are less well developed, on the other hand, suffer higher rates of unemployment and lower wages.

CHART 45



Source: Economic Policy Institute, State of Working America, 1992-1993.

Traditional public training policies in the United States have focused on the displaced and the disadvantaged. These groups clearly need continuing assistance, but the increasing importance of education and training means that policy must concentrate on building a training system for all workers, not just those perceived to be at immediate risk in the labor market.

Furthermore, training must be integrated with demand-side policies, including productivity-enhancing programs in technology and work organization. As Burtless and Mishel point out, "the biggest challenge is to create jobs with good wages for those without a college degree." Given the depth and duration of America's earnings and inequality problems, the full range of economic policies must be aimed at this goal.

V

CONCLUSION

The year 1993 saw an economic turnaround that was long awaited by recession and debt-weary Americans. Significant progress was made in getting the federal deficit under control. The Congress enacted the President's program of deficit reduction, balanced between spending cuts and tax increases concentrated on the wealthiest Americans. Consumer and business confidence rose, as did private investment and employment.

Most importantly, the economic gains of 1993, unlike those of the 1980s, are built upon a solid base of fiscal responsibility and real investment growth. Unlike growth periods of the 1970s, inflation is very low today. To sustain the healthy recovery begun in 1993, it is crucial that interest rates stay low in order to offset the continuing fiscal contraction from further reductions in the federal budget deficit.

Significant economic challenges await us in 1994 and for the remainder of the decade. First, it is essential to address the crisis in health care. Health costs continue to consume too large a share of GDP, crowding out wage growth and business investment. Comprehensive health care reform is necessary.

A second major challenge is the continuing low level of public investment. The American economy will not reach its full growth potential without more and better focused investment in education, training and physical infrastructure.

Perhaps the greatest challenge will be restoring real income growth for the majority of the American people. In spite of 1993s economic successes, real family income remains stagnant, having been on a downward slope for almost two decades. Of special concern are the declining earnings of the noncollege educated workers who comprise three-fourths of the work force.

To address these challenges, a sound economic foundation is essential. In 1993, that foundation was put in place. Economic policy now must keep the economy on a steady growth path, while simultaneously addressing our long-term structural problems.

Republican Views

I

State of the Economy and the Economic Outlook

Recent Economic Performance

Not so long ago, much was heard of the end of business cycles through finely tuned policies from Washington. Sobered by events, little is heard of this any more.

Since March 1991, the economy has been recovering from its ninth postwar recession. The recession began in July 1990, according to the National Bureau of Economic Research (NBER), following 92 consecutive months (nearly eight years) of economic growth, the longest peacetime expansion in American history.

The eight-month recession spanning 1990-91, of course, is only part of the story. The origins of the recession trace back earlier, at least to the beginning of the Bush Administration. The Reagan economic expansion, fostered by lower taxes, reduced government regulation and less inflationary monetary policy, really ended by January 1989. Since then, the Bush and Clinton Administrations reversed the Reagan policies in favor of increased tax rates, regulations and spending.

The Federal Reserve Board of Governors also changed policies, slamming on the monetary brakes, apparently in an abortive attempt to reduce price inflation to zero. The money supply as measured by M1 increased by only 12 percent in the four years from April 1987 to April 1991, a dramatic reduction from an annual average of over 8 percent since 1982. Crushed by rising taxes and a growing regulatory burden, especially in the financial services sector, the hoped-for soft landing never materialized. After four years of negligible monetary growth, the Fed reversed course in the Spring of 1991 and began pressing hard on the money accelerator in an earnest effort to stimulate the economy.

Most recessions since 1945 have been sharp intervals of adjustment between two relatively long periods of economic expansion. The 1990-91 recession, however, was not. Instead, the three-quarters of official recession during 1990-91 were more like a shallow trough, part of a continuing deceleration in economic growth, rather than a sharp punctuation between two spans of relatively strong growth.

Stagnation prevailed for almost two years before the recession began. For example, real business output grew by an anemic 0.5 percent between the fourth quarter of 1988 to the fourth quarter of 1989 compared to real growth of over 4 percent in both

1987 and 1988. Real business output has managed less than a 9.0 percent increase since the slowdown began in the fourth quarter of 1988, a scant 1.7 percent a year. These data highlight how weak the recovery has been, one of the weakest on record.

During 1990, real business output grew only 0.7 percent, and total hours worked essentially remained flat (up 0.1 percent). Labor costs are the most important cost of doing business, and labor costs per unit of output increased 5 percent in 1990, the highest increase since the recession year of 1982. This dramatic increase in business costs in the midst of a weak economy priced millions of people out of work.

During 1991, business output declined 1.3 percent. Labor costs per unit of output increased another 3.8 percent in 1991, driving hours worked down by 2.3 percent, the sixth largest decline in employment of any year since the end of World War II. Between 1990 and 1991 the unemployment rate rose from 5.4 to 6.6 percent. The hardship grew.

During 1992 output grew 2.9 percent and more than offset the 1991 decline in output. However, this growth did not directly translate into new jobs and the recovery was tagged a "jobless recovery."

Meanwhile, behind the political rhetoric of a presidential campaign, painful but necessary labor market adjustments were occurring that made 1992 a pivotal year in the recovery. These adjustments set the stage for the improved economic performance to come in 1993. Hourly productivity jumped 3.4 percent in 1992 and total hours worked actually declined 0.4 percent. The unemployment rate peaked at 7.7 percent in July 1992. Such hardship is silently instructive. Labor costs per unit of output rose only 1.7 percent in 1992, the smallest effective increase in labor costs since the recovery year of 1983, and the second smallest boost in 28 years.[1] Labor market flexibility finally began to offset some of the policy errors manufactured in Washington. **In effect, workers gradually produced and priced themselves back into jobs during 1992.**

During 1993 the economic expansion continued, although the pattern was disturbingly erratic, with half of the gain coming in the last quarter. Business output grew 3.6 percent for the year, a larger increase than the 2.9 percent gain for 1992. Yet the fourth quarter to fourth quarter gains in 1992 and 1993 were an identical 4.1 percent. Total hours worked grew by 1.8 percent last year and translated into a payroll gain of 1.9 million jobs, an increase of 1.8 percent. Productivity grew by 1.7 percent during 1993, half the gain of 1992, yet unit labor costs only rose 2.0 percent, the third smallest

[1] In 1983, unit labor costs grew only 1.5 percent and therefore contributed mightily to the biggest expansion year of the Reagan expansion -- 1984 -- in which hours increased 5.6 percent, the highest ever recorded.

increase since 1965. In the words of George F. Will, labor continued to be "docile." As a result, unemployment eased back down to 6.7 percent for the year, and stood at 6.5 percent in March 1994. Workers continued pricing themselves into jobs.

The first quarter of this year has seen a familiar pattern reemerge. After a robust fourth quarter, economic growth again has slid to a moderate 2.6 percent annual real growth rate in the first quarter -- a lower rate than in any quarter during the much maligned growth year of 1992. The Clinton economy begins to resemble the Bush economy.

THE SHORT-RUN OUTLOOK

In the short run, the stage is set for continued moderate expansion during 1994, though the pace certainly will be more subdued than the torrid 7 percent of the last quarter of 1993, which Federal Reserve Chairman Greenspan termed an aberration.[2] Economic performance in 1994 will likely fall considerably short of the robust levels achieved during the Reagan years. The Commerce Department's Index of Leading Economic Indicators finally declined 0.1 percent in February after increasing for six straight months while factory orders fell 1 percent in February ending a string of six straight months of increases.[3]

On the side of economic strength, auto makers are enjoying their best year since 1988. Claims for unemployment benefits continue trending down in 1994. The six-month cumulative increase of 2.6 percent in the Index of Leading Economic Indicators prior to its February decline was the largest since a 6 percent rise over seven months in 1983. The consensus forecast of the 51 economists polled by the newsletter *Blue Chip Economic Indicators* (April 10, 1994) predicts real growth of 3.7 percent in 1994, while both the Clinton Administration and the Congressional Budget Office (CBO) are more restrained, forecasting 1994 real gross domestic product (GDP) growth at 3.0 and 2.9 percent respectively.

The Administration and its allies contend that "the economy's underlying rate of growth has accelerated"[4] and that the Clinton tax increases and budget bill have been the cause. Arguing that all is well, Senator Jim Sasser said:

> Look what is happening in the economy. [Referring to a chart] Look at that line [real business investment in billions of 1987 dollars], going almost straight up, as this economy recovers. This real business investment is the best evidence we have that we have a robust

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[2] Hearing before the JEC with Alan Greenspan, January 31, 1994, pg. 17.

[3] U.S. Dept. of Commerce, *Commerce News*, February 24, 1994, pg. 1.

[4] Sasser, Senator Jim, *Congressional Record*, March 22, 1994, pg. S3405.

economy on our hands for the coming year and for the outyears. . . . Look at these leading economic indicators. Beginning in the fall of 1993, that line is going almost straight up. That is an indication of robust economic growth to come.[5]

On the side of weakness, this optimism may be based on a reflection in the rear-view mirror. This recovery is aging by historical standards and yet remains relatively weak. For example, the average length of peacetime economic expansions has been 43 months, and this recovery is now in its 38th month. It has been a two-thirds recovery in terms of both employment and output gains at this stage of the cycle.

While business investment, as usual, has been the spark plug of this recovery, there is evidence that it is slackening off from its earlier pace. Durable goods orders took a surprising tumble in February (down 2.5 percent), and although the pace picked up somewhat in the first quarter, unfilled orders for durable goods decreased for the 12th time in 13 months. On top of this, exports declined by $15 billion, or about 3 percent, in the first quarter, and the pace of nonresidential fixed investment skidded. Most disturbing, two-thirds of the first quarter growth in GDP consisted of inventory build up. All of these reports are consistent with February's decline in the Index of Leading Economic Indicators. The April tumble in the stock and bond markets also suggest that all is not well with this recovery.

Another peril has become obvious to every observer: Inflation flags are flying full mast. The interest rate on long-term treasuries is up more than one full percentage point since September, and the market value of interest-rate-sensitive utility stocks is off 20 percent during the same time period. Also, there are early signs of higher inflation expectations in commodity prices: gold has moved up to nearly $400 an ounce and the spot, and commodity futures price indexes are up sharply. The KR-CRB Index is up about 13 percent over one year earlier, and the Dow Jones Futures Index is up about 20 percent since June despite oil at $15 a barrel.

In the immediate run, a major threat continues to be that interest rates, after bottoming out in early 1993, will continue moving higher. A significant upward move in interest rates would dampen growth and worsen the budget deficit.

[5] *Ibid.*, pg. S3407.

THE TWO-THIRDS RECOVERY

Real GDP has increased only 8.7 percent since the trough of the recession (1991:I to 1994:I) -- half the progress made in other recoveries at the same stage.[6] Employment has increased only 2 percent since the recession ended over three years ago, less than half of the job growth of other recoveries at the same stage.[7] Last year's gain of 1.9 million new payroll jobs, the best gain since 1989, was only three-fourths the average of nearly 2.6 million new jobs per year created from 1983 to 1988. An extraordinarily high one-in-three new jobs in the private sector last year was in eating and drinking establishments and the temporary help industry where both wages and working hours are below national norms.[8] Health services, an average wage industry, added one in six jobs. These three industries accounted for a majority of the net gain in private employment, a narrow base for growth in the productive sector. By contrast, high-tech and high-skilled jobs dominated job creation in the 1980s. For example, between 1983 and 1992, managerial and professional occupations grew twice as fast as overall employment growth, while food preparation and service occupations grew at the overall employment rate.[9]

By historical standards, business investment spending has remained weak throughout this recovery. Fixed investment net of depreciation ran at about 5 percent of GDP during the 1980s but since 1989 has averaged only 2.9 percent. It rose to 3.5 percent in the last quarter of 1993, but the Census Bureau reports that businesses plan only a 5.4 percent increase in spending for new plant and equipment in 1994. With nominal GDP expected to grow 6 percent, investment as a percentage of GDP will not increase again this year.[10] The first quarter skid in nonresidential fixed investment is consistent with this forecast.

Capital spending lacks breadth and is concentrated on two industries: computers and trucks. Real outlays for information processing and related equipment plus trucks and buses went up 27 percent in 1993 compared to 7.6 percent for all other categories

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[6] Based upon the *Economic Scorecard*, Institute for Policy Innovation, Lewisville, Texas, Fourth Quarter 1993, pg. 2.

[7] *Ibid.*, pg. 4.

[8] *Heineman Economics*, "Prospects for Money and the Economy," March 14, 1994, pg. 1.

[9] Bureau of the Census, *Statistical Abstract of the United States, 1993*, Table 644.

[10] *Economic Scorecard*, Fourth Quarter 1993, pg. 4. The Commerce Department reported April 7th that U.S. businesses plan to increase investments in new building and equipment by 8 percent this year on top of last year's 7.1 percent, but even this may not raise the net investment share of GDP.

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of capital spending. Fixed nonresidential investment exclusive of computers and trucks averaged 6.9 percent of GDP in the current expansion, a postwar low, and two percentage points below the 1965-85 average.

Two legislative actions in 1993 bear on the economy for 1994. First, Republican opposition in the U.S. Senate to the so-called Clinton "stimulus package" prevented congressional passage of a package that would have increased the budget deficit by $17 billion over four years and pressure for even higher deficit spending (see Chapter II). Second, without a single Republican vote and by a single vote majority in each House, Congress passed the so-called deficit reduction legislation that raised taxes $241 billion over five years.[11]

The Administration and its allies in Congress portray their tax increase of 1993 as an elixir that reversed four years of stagnation. One of the most outspoken supporters of last year's budget bill, Senator Sasser, illustrates the Democrats' bold claims:

> There is now a developing consensus that the economy's underlying rate of growth has accelerated. . . . The verdict is in, and the verdict is that we have dramatically changed the economic direction of the United States of America for the better. This economy is on the path to renewal with rising output, increased employment, and falling deficits.[12]

Yet last year's budget bill and tax increase are mere continuations of the failed policies of the previous Congress and Administration. The few quarters of strong economic performance over the last 12 quarters mask the underlying weaknesses in the economy, and the disappointing first quarter GDP report lifted the veil again. Further, the illusion of robust economic health is heightened by statistical manipulation, making good economic news look better than it really is. For example, the Chairman of the Senate Budget Committee said:

> Many of our colleagues, especially those on the minority . . . were clinging to the wreckage of a failed economic philosophy. . . . Instead of seeing a robust economy resulting from this lowering of the deficit, they saw the Four Horsemen of the Apocalypse coming over the horizon. The *Congressional Record* is full of their anxieties and prophecies of doom. Real gross domestic product -- that is the gross domestic product corrected for inflation -- grew more than 3 times as fast in the first year of the Clinton Presidency than it did during the preceding 4 years.[13]

This hyperbole is wrong on at least two counts. First, whatever the effects of last year's budget bill and tax increases may prove to be, they had not taken hold at the time the Senate Budget Committee Chairman spoke. Economic decisions do not "turn on a dime." Republicans predicted the Clinton tax increases of 1993 would have detrimental

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[11] CBO, *Economic and Budget Outlook*, September 1993, pg. 29.

[12] *Op.Cit.*, *Congressional Record*, pg. 3405.

[13] *Op.Cit.*, *Congressional Record*, pg. S3404.

effects on investment and growth but they did not claim that these deleterious effects would occur **before** the tax increases even took effect. Democrats have twisted Republican warnings beyond recognition, taking them out of context and parodying the time frame in which they were meant to apply. The Clinton tax increases did not go into effect until October 1st, and most individuals did not really find out how much their taxes went up until April 15th.

Second, on a fourth quarter to fourth quarter basis, output growth actually was no better in 1993 than in 1992. The growth spurt in 1993:IV had nothing to do with Administration's fiscal policies, which did not even pass Congress until a few weeks earlier. Growth in 1993 was a continuation of the recovery that took hold in 1992, enhanced by three years of stimulative monetary policy and pliant labor markets. While this two-year period may be good compared to the preceding three years, it is substandard compared to other recoveries at a similar point.

Therefore, the Clinton budget and tax increase passed in August 1993 did not slow the recovery because they did not go into effect until October 1, too little time to extract their price on investment and growth, and the changes were small relative to the rapid inflation of money spending and the adjustments in relative prices and wage rates that were in place last fall.[14]

The market process had already moderated increases in hourly compensation, thereby stimulating employment and output. The natural recuperative powers of the market system recoordinated business activity by bringing more and more prices into better alignment with each other. This phenomenon also was reflected in the recent decline in labor's share of national income (labor productivity gains outpacing pay), higher corporate profits, and optimism among business leaders.

As the first quarter GDP report reveals, a prediction of "robust economic growth to come" is premature. President Clinton's new taxes -- the government's most recent new impediment to economic growth -- have not yet taken full effect, and the economy may be slowing already. So the moderate economic expansion, which began in 1992, will unfold for much of this year as the full weight of the Washington's new elixir and other detrimental economic policies begin to take their toll. And take their toll they will.

Monetary Policy Since 1988

After four years of extraordinarily tight monetary policy, the Federal Reserve Board's monetary policy has been very accommodative over the last three years. Price inflation

[14] As Paul Gigot observes in his column, "Unlike George Bush, Mr. Clinton was fortunate enough to pass his tax hike at the beginning of an economic expansion, not the end." *The Wall Street Journal*, "When Hillary's Bull Bill's Bear," April 1, 1994, pg. A8.

has remained in check because there has been slack in the U.S. and world economies combined with relatively slow growth in money spending as businesses and households increased their average cash balances (higher money demand). This was partly a predictable response to lower interest rates, as well as a trend in the overall willingness to hold money relative to income (lower velocity of money). In addition, rather than translating into commercial loans and business spending, a substantial amount of the new money created by the Fed found its way into equity markets and remained there, fueling part of that market's rapid appreciation.[15] Moreover, the regulatory credit crunch that made it difficult for many businesses, especially small businesses, to increase their spending as they wanted to during the recovery has ended. As the Shadow Open Market Committee notes, this "slow growth [in spending] appears to have ended."[16] If so, the velocity of money is likely to increase and thereby end the Fed's run of luck on inflation.

The recent down and up in money growth cannot be dismissed as accidental. It was largely intentional. The primary means of greenback creation is the Fed's net purchase of U.S. government debt. This is the "magic checkbook," or monetization of the debt, the net result of the bank's open market operations. The growth of the Federal Reserve's holdings of U.S. government securities is shown in Table I.1, column 2.

[15] Indicative of this trend is the fact that during 1992 and 1993, while M1 was growing at double-digit average annual rates, M2 grew by only 1.5 percent per year.

[16] *Heineman Economics*, March 14, 1994, pg. 3.

Table I.1 — **Annual Percentage Change in Money Supply, Money Spending, Hourly Compensation and Hours, 1980-1993**

Year	% Change M1	% Change Federal Reserve U.S. Sec.	% Change Money Spending	% Change Hourly Compensation	% Change Hours of All Persons
1980	6.8%	4.3%	8.8%	10.7%	- .8%
1981	6.8	7.9	11.9	9.4	.7
1982	8.7	6.4	3.9	7.6	-2.4
1983	9.9	9.1	8.1	3.8	1.8
1984	6.0	5.9	10.9	4.3	5.6
1985	12.3	12.7	6.9	4.5	2.1
1986	16.9	9.0	5.7	5.0	0.6
1987	3.5	10.8	6.4	3.6	3.0
1988	5.0	6.7	7.9	4.4	3.3
1989	.9	-4.2	7.2	3.5	2.5
1990	4.0	3.7	5.6	5.7	0.1
1991	8.6	13.4	3.2	4.9	-2.3
1992	14.2	10.7	5.5	5.0	-0.4
1993	10.1	10.8	5.6	3.8	1.8

Source: *Economic Report of the President*, February 1994, *Economic Indicators*, February 1994, and Federal Reserve System, *Annual Statistical Digest*, and *Federal Reserve Bulletin*.

The Fed's New York desk has complete control over net additions to its portfolio of U.S. securities. Between 1981 and 1988 its holdings of securities expanded at an average annual rate of 8.6 percent. But the Fed pared its holdings by an astounding 4.2 percent in 1989. This was the first reduction in the Fed's portfolio since the 1950s. To put it mildly, this was an extremely deflationary move. Furthermore, in 1990 the Fed increased its holdings a modest 3.7 percent, virtually assuring a business recession.

But the Fed's twists and turns were hardly over. The Fed reversed its policies, increasing its portfolio a whopping 13.4 percent in 1991, another 10.7 percent in 1992 and a 10.8 percent gain in 1993. The early pace in 1994 is double-digit, continuing the Fed's three-year run of "stimulus."

Why do changes in the stock of money have such real effects on economic activity? Because millions of price relationships become distorted. The last strong year of employment growth was 1989, when hours went up 2.5 percent. Then employment fell or remained stagnant and did not grow until 1993. In the 1990-91 downturn, unsold goods and services piled up because their prices were no longer consistent with market conditions. Excess supply ("overproduction") is almost the definition of a business recession. Classical economists like Robert Malthus once called depressions

for goods and services that are too high for full sales, full production and full employment.

In the latest recession, prices had been increasing at no-longer sustainable rates, given the Fed's deflationary policies from April 1987 to April 1991. Eventually, after a great deal of economic pain, people adjusted to the new reality and markets moved toward market-clearing prices. Growth resumed because prices came into better relation with each other, especially the relationship between labor costs and product prices. The Fed reflated the money supply too, stimulating recovery in the short term.

This view of the importance of relative prices is supported by almost all economists. For example, John Maynard Keynes wrote, "There is no positive means of curing unemployment except by restoring to employers a proper margin of profit."[17] Benjamin M. Anderson, Jr. wrote,

> With respect to business, there is one outstanding fact. Business expands when profits are improving. Business contracts when profits decline or when there is a serious threat to profits. Now, profits are what is left of gross income after costs are subtracted, and the labor factor in costs is overwhelmingly important.[18]

Milton Friedman made the argument pointedly in his Nobel-prize acceptance speech:

> ...the apparent tendency for an acceleration of inflation to reduce unemployment...can be explained by the impact of <u>unanticipated</u> changes in nominal demand on markets characterized by (implicit or explicit) long-term commitments with respect to both capital and labor.[19]

To be sure, the analysis is complicated by the presence of huge, interventionist governments. All modern economies are **political economies**, rather than capitalism with "nightwatchmen" governments. Sustained idleness of labor and capital is partly market-determined but mostly politically driven. People make mistakes, they over- and under-anticipate the rate of price inflation, they set their prices too high or too low, they adjust after delays, they "grope" and they hold out in the hopes that officials will resume monetary inflation because of the political commitment to "full employment." Market adjustments to new conditions can be slowed by union and government-imposed prices for labor in certain markets, workplace rigidities, mandated benefits, employment and payroll taxes, redistribution to the dependent and unemployed, and other regulations that raise business' overhead costs.

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[17] Keynes, John Maynard, *Essays in Persuasion*, London: St. Martin's Press, 1972 [1931].

[18] Anderson, Jr., Benjamin, *Economics and the Public Welfare*, Indianapolis: Liberty Press, 1979 [1949], pp. 436-437.

[19] Friedman, Milton, "Nobel Lecture: Inflation and Unemployment," *Journal of Political Economy*, 85 (June 1977), pg. 456.

In the downswing of 1990-91, wage rates did not react quickly to the unanticipated deceleration in money growth while other business costs continued to be pushed up by new government regulations. During 1990 and 1991, hourly compensation rose 10.9 percent while money spending only rose 9.0 percent, making a reduction in employment inevitable. Price-cost margins got squeezed, and many businesses found that they had to reduce their losses through shut-downs, lay-offs and lower rates of production.

The reverse happened during the 1992-94 upturn. Hourly compensation grew 5.0 percent in 1992 -- too much to increase jobs -- but only grew 3.8 percent in 1993. The decline in compensation increases followed the hardship of 1990-91 and the jobless recovery of 1992. So both employers and workers reacted predictably to the lack of new jobs. With compensation going up very little, growth in money spending outgrew compensation in both 1992 and 1993, leading to employment gains in 1993. The margin between what businesses could get for their goods in services (product prices) and their costs of production widened for many businesses, leading them to pursue higher profit by increasing production, boosting sales, and adding labor and equipment.

Short-run fluctuations in total hours worked can be explained statistically very well by changes in only two factors:

- Changes in the volume of money spending (strongly influenced by monetary growth), and

- Changes in hourly compensation.

Rapid increases in money spending, all else equal, stimulate employment in the short run. Increases in labor compensation, on the other hand, depress the amount of hours employed. That is, aggregate increases in the demand for labor raise employment while boosts in hourly labor cost reduces the amount of labor demanded. A simple linear equation captures this reasoning and fits the postwar data.[20]

Fiscal And Regulatory Policy

Monetary fluctuations combined with market responses, especially in prices and labor compensation, explain much of our recent business cycle experience. Each recession and recovery, however, is unique.

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[20] If we use annual data for 1980 to 1993, for example, we have:

$$\%\text{Chge Hrs} = .08 + \underset{(.10)}{.74}(\%\text{Chge Money Spend}) - \underset{(.11)}{.76}(\%\text{Chge Comp. per Hr})$$

Observations = 14, d.f. = 11, $R^2 = .88$

The equation says that if hourly compensation rises less than total spending, then hours increase. Changes in the growth rates of compensation and money spending account for most of the variation (88%) in annual hours worked. The model works well with both quarterly and longer U.S. time series too.

Fiscal and regulatory policy powerfully affect the business economy over the long run but there are short-run effects of fiscal and regulatory change too:

- The 1990 budget deal raised taxes just as we entered a recession, aggravating the problem of expanding private production and employment in both the short run and long run.

- The national minimum wage increased 27 percent in 1990-91, raising the cost of unskilled labor and decreasing its employment in the short run.

- New regulations and mandates like the Americans with Disabilities Act threatened to raise the fixed costs of businesses substantially and hence reduce employment.

- New unemployment benefits to subsidize the unemployed encouraged more withholding of labor and delayed the wage adjustments necessary to price workers back into jobs (benefits nearly doubled from $13.7 billion in 1989 to $24.5 billion in 1991).

- Corporate debt overhang required restructuring.

- A regulatory credit crunch from zealous regulation of the financial services industry reduced the amount of investment capital available to entrepreneurs and small businesses.

- Recessions appeared in Canada, Europe and Japan at nearly the same time.

Monetary Policy, Real Growth and Inflation

A clear understanding of our recent history requires an appreciation of the work performed each day in the economy by Adam Smith's invisible hand. The market economy consists of literally millions of prices, many changing daily. The price system coordinates millions of individual plans and choices reasonably well most of the time, despite the messy appearance. In other words, prices dovetail independent actions into a harmonious whole. However, if a lot of prices are substantially "wrong" for a sustained period of time, then chaos, or serious coordination failure, results. Individual plans and actions no longer dovetail. In particular, massive unemployment of both labor and capital services signals that their prices are too high for market conditions. As Edwin Cannan wrote in 1932: "Mass unemployment occurs when the phenomenon of asking too much becomes general."[21]

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[21] Cannan, Edwin, "The Demand for Labour," **Economic Journal**, 42 (September 1932), pp. 357-370.

For policy makers too, the question is, how much is too much? One way economists approach this question for the economy as a whole is to study the economy's past growth as a benchmark against which to gauge economic performance. This approach asks, what growth path would the economy trace out over time if the economy was always at full employment? Over time, output growth at full employment depends on growth in labor and capital and growth in the productivity of these factors of production.[22]

If predicted growth in the labor force is added to a predicted rate of increase in labor productivity (output per hour), they yield a forecast of growth potential in the economy. At a recent Joint Economic Committee (JEC) hearing, Fed Chairman Alan Greenspan commented on growth potential:

> CBO estimates that the long-term growth rate is, roughly, 2.5 percent at an annual rate. I want to emphasize, however, that we should be a little careful about taking numbers of growth as though they are rigid and that we should not endeavor to improve them, because **there is a considerable amount of gain in productivity that could occur which we will not be aware of except in retrospect.** And so we have to be careful not to look at economic policy as being a situation in which there is a fixed level beyond which we are afraid to move (emphasis added).[23]

A long-term growth rate of 2.5 percent separates into an annual growth in labor supply of 1.5 percent and the mediocre growth of productivity of 1 percent a year achieved over the last two decades.

The Fed Chairman's admonition that growth potential numbers should not be viewed as rigid constraints is extremely important, especially since annual productivity improvement has dipped as low as -1.9 percent in 1974 and soared as high as 8.5 percent in 1950. Between 1889 and 1973 productivity increased by an average of 2.4 percent a year. Labor productivity grew at an average rate of 3 percent between 1948 and 1973. Since 1973, however, productivity growth has slumped dramatically, averaging 0.8 percent growth between 1973 and 1981, rising to only 1.1 percent between 1981 and 1993.[24]

Productivity and growth numbers are useful historically, but they are unreliable guides to the future. No one knows growth potential with any degree of certainty. Nor

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[22] Dornbusch, Rudiger and Stanley Fischer, *Macro-Economics*, McGraw-Hill Book Company, New York, 1978, pg. 549.

[23] *Op.Cit.*, JEC Hearing, pp. 39-40.

[24] Part of the explanation for this slump in productivity growth was demographic as large new cohorts of young and inexperienced workers entered the labor force during this period. Another important explanation for the decline in productivity growth were government policies that depressed capital investment, raised the number of mandated unproductive manhours, and reduced work effort. Hence growth potential could be increased substantially by removing government impediments.

do comparisons between quarterly growth rates during a recovery and an alleged growth potential number provide a guide to the risk of future price inflation. Economic growth should not be confused with inflation. As the Reagan era demonstrated, strong growth in jobs and income is perfectly consistent with disinflation. **Creating jobs does not cause inflation.**

Nor can swings in monetary policy increase long-term capacity for real growth. Economists would also subscribe to the following statement:

> Departures from normal and expected rates of change in monetary aggregates can generate real economic effects on production, employment, and output.[25]

Even in an economy operating at full employment, changes in monetary policy can depress growth beneath its (unknown) potential or induce temporary spurts of real growth in excess of growth potential.

Expansions do not die of old age. They are killed off by policy mistakes made in Washington, D.C. Only the errors of governmental officials are big enough to throw an economy the size of the United States' into discoordination and keep it staggering below its potential year after year. All downturns are caused by monetary, fiscal and regulatory mistakes, including price controls and other forms of market interference. In most downturns, changes in monetary policy play a dominant role, including the most recent recession. In upturns, market flexibility and recoordination play a dominant role, sometimes aided by monetary growth.

A considerable amount of confusion exists over how swings in monetary policy affect individual prices, the real economy, and the price level. Part of the confusion results from a refusal to heed Chairman Greenspan's advice not to view growth potential numbers as fixed parameters. And part of the confusion results from forgetting that inflation first, foremost and always is a **monetary phenomenon with long and variable lags.**[26]

Surprisingly, the mechanism of inflation is one of the best understood phenomena in economics. If economists know anything at all, they know how to create or end an inflation. Throughout history, economists have never discovered a sustained rise in the general level of money prices without finding a sustained increase in money supply too, an increase well in excess of the growth of output. Nor have they found a sustained increase in money supply without also finding price inflation. In fact, an old definition

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[25] Buchanan, James M. and David I. Fand, "Monetary Malpractice: Intent, Impotence, or Incompetence?," *Critical Review*, Vol. 6, No. 4, May 1993, pg. 457 [457-469].

[26] Milton Friedman's Nobel-prize acceptance speech remains the most lucid description of the inflation process and how monetary policy affects the real economy (Friedman, Milton, "Nobel Lecture: Inflation and Unemployment," *Journal of Political Economy*, 85 (June 1977), pp. 451-472).

of inflation is "a rapid growth in the stock of money and credit resulting in a continuing rise in the general level of prices." As many have put it, inflation is "too much money chasing too few goods."

Price inflation confirms a fundamental law in economics: if something increases rapidly in supply, all else equal, its relative value must fall. A rapid increase in the amount of dollars in the hands of the public, compared to increases in the amounts of other goods, necessarily reduces the market value of each dollar. A good numerical rule of thumb is that a sustained rise in prices is impossible if monetary growth is in line with the growth of real production.

To refine the argument slightly, the exchange value of a unit of money (its market value or "price" in terms of other goods) will remain constant if the stock of money and the demand for money (willingness to hold money) both grow at the same rate. During serious inflations, the demand for money does not grow as rapidly as the Fed prints money, driving down the purchasing power of the dollar. People have cash balances that are too large relative to current prices and their other assets, so they spend it to decrease their balances, but the money does not leave the system. Ultimately, a higher price level brings dollar demand into equality with dollar supply, and households and firms have satisfactory money balances at the higher price level.

The Fed does not directly determine the value of money nor its rate of depreciation because the Fed only influences its supply, not demand for it. In a stable environment, the demand for money tends to be a steady function of a few variables like real income, wealth, interest rates, price level, and anticipated price inflation.[27] Public demand for money tends to grow apace with output, so more jobs and output actually decrease price inflation, holding all else constant. This is not an iron law, however, because even on a relatively steady growth path the demand for money can grow more or less rapidly than output, depending on changes in interest rates, consumer preferences, payment procedures, and so on. The monetary authorities can avoid substantial inflation or deflation in the price level, with a lag, by gradually adjusting money growth to newly evolving patterns of demand.

Money demand can deviate sharply if output departs substantially from long-run trends (e.g., "bad harvest" or in today's political economy, "bad policy") and more importantly if expectations of future inflation increase. Ironically, an increase in interest rates is not anti-inflationary because it lowers the demand for money and thereby depreciates the dollar. But this reduction is not really an independent "engine of inflation" because interest rates typically go up in response to higher anticipated price inflation. Again, the underlying cause of inflation is excessive growth in money supply rather than excessive job and output growth.

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[27] Friedman, Milton, ed., *Studies in the Quantity Theory of Money*, 1956.

Public expectations about inflation can be volatile in an unstable environment. Lags in defensive behavior by the public explain why price inflation tends to remain under control early but outruns accelerating money growth during a hyperinflation, when everyone plays "hot potato" trying to avoid holding on to depreciating paper money for very long.

The limits to economic growth can be pictured as a shifting set of constraints, some made in Washington. According to popular non-monetary theories of inflation, as the economy approaches something called capacity, supply pressures develop in various sectors and prices are bid up, ultimately resulting in price inflation. But what fuels this on a sustained basis? In truth, there is no nonmonetary theory of inflation that makes any sense.[28] Supposedly, a surge in demand for goods and services in general ("aggregate demand") "pulls" prices up across the board, especially if "aggregate supply" is restrained by inertia, taxation or capacity limitations. Skeptics rightly question how demand could constantly outstrip supply. As David Ranson says, "Surely, demand must originate from purchasing power, purchasing power from wealth, wealth from income, and income from the ability to produce (and hence supply) goods and services."[29] The theoretical failure of non-monetary theories of inflation was understood early in the nineteenth century by Jean-Baptiste Say and other classical economists.

But we are not confined to logic alone in rejecting this "fear of growth" theory of inflation. Table I.2 shows that the "overheating" theory of economic growth is wrong empirically.[30] The reverse is much nearer to the truth for the United States in recent decades. In years of slow job growth, inflation was high and in years of rapid job growth, inflation was low. Not only was the old Phillips theory wrong, the new Phillips theory is wrong too.

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[28] Ranson, David, "Inflation," in David R. Henderson, ed., *The Fortune Encyclopedia of Economics*, New York, NY: Warner Books, 1993, pp. 211-216.

[29] *Ibid.*, pg. 214.

[30] *Ibid.*, pg. 215.

Table I.2 — Inflation Versus Jobs The Historical Record, 1953-90

	Average Increase In Consumer Prices	Average Growth of Employment		
		Same Year	Next Year	Cumulative
The Fifties (1953-62)				
4 highest-inflation years	2.3%	0.8%	0.3%	1.1%
4 lowest-inflation years	0.5	1.4	2.4	3.8
The Sixties (1962-71)				
4 highest-inflation years	4.9%	1.6%	2.0%	3.7%
4 lowest-inflation years	1.8	2.2	2.4	4.7
The Seventies (1971-80)				
4 highest-inflation years	11.3%	1.1%	1.0%	2.0%
4 lowest-inflation years	5.4	3.5	3.4	7.1
The Eighties (1980-89)				
4 highest-inflation years	6.4%	1.6%	0.7%	2.4%
4 lowest-inflation years	3.1	2.1	2.8	4.9

Data: Consumer Price Index, all urban consumers; civilian employment (labor force survey).
Source: Bureau of Labor Statistics.

If monetary policy is more-or-less correct, changing prices lead to self-correcting adjustments by producers and consumers. Prices rise to mitigate shortages but the general level of prices cannot go on an upward spiral unless money has reached the wallets of governments, households and businesses that is excessive relative to their wishes, in effect, relative to goods production and the price level.

If the central bank attempts to use monetary policy to push the real economy beyond production limits, then, of course, a monetary inflation is possible and probable. As long as the central bank persists in creating too much money, this spiral will continue and trigger a burst of higher real growth. Then prices and wages move higher too. Eventually, producers and consumers realize what is going on, and they adjust or even overadjust their prices. The monetary boost to real economic growth eventually dissipates because the central bank must back off its inflation sooner or later. After all, money must be in scarce supply if it is to be used in exchange at all. And the economy is left with stagflation, the unhappy combination of high unemployment and high price inflation.

Most economists now accept this basic theory. The problem arises when politicians, members of the media, investors and economists themselves latch onto real economic variables as reliable indicators of the future path of inflation. While it is true that real growth will temporarily exceed growth potential if monetary policy was inflationary, it does not follow *post hoc, ergo propter hoc* that if observed real growth

exceeds an estimate of growth potential that it is inflationary. As Table I.2 demonstrates, almost the reverse is true: real growth is associated with lower inflation. Both the old and "post-modern" Phillips curves are wrong. Sometimes we may observe "too much" growth *ex post*, that is, growth in excess of growth potential. But, as Greenspan warns, there is no reliable way *ex ante* to know whether growth is "too fast."

During the mid 1980s, the economy grew at a rapid rate largely as a result of the Reagan economic program. Reagan economic policies probably increased real growth potential substantially above 1980 capacity by removing some impediments to growth. By 1987, however, the Fed became very sensitive to inflation and it perceived that the economy was growing "too fast." Yet, the economy probably was behaving as one would predict if the Reagan economic policies were working, especially over the very long run.

Had the Fed simply engaged in a gradual deceleration in monetary growth with an eye to gradually lowering the inflation rate from four-something to the two-something that prevailed in the 1950s, money growth would have been brought into line with economic performance and a recession could have been avoided, even though growth would have slowed under the weight of the new onslaught of taxes and regulations. Instead, the Fed became impatient and attempted to squelch inflation too quickly.

Real growth never overheats the economy. It is the central bank that "overheats" the money supply and then "freezes" it. It is the monetary authority's actions that lead to inflation and recession. The so-called overheated economy is **an effect of inflation** rather than **the cause of** inflation. Since inflation is not caused by an overheated economy, the solution to inflation is not to slow economic growth. Growth, in fact, "sops up" inflation. The way to control inflation is to get monetary policy right, by accident or design, with the effect of allowing the economy to approximate its growth potential. If inflationary monetary policy persists too long, the only path back to "normalcy," unfortunately, passes through a business recession.

This same framework of analysis provides additional insight into what transpired in the political economy over the past couple of years. The Clinton Administration and its supporters in Congress now claim that their tax increase last year fundamentally increased the economy's capacity to grow, and they point to recent economic strength as evidence. Yet part of today's economic vigor appears to be a classic instance of monetary stimulus, with a lag, boosting the economy.[31]

The conventional wisdom now appears to be that the economy is "growing too fast." Even if that were true, the standard prescription -- that the Fed should take deliberate action to slow economic growth -- is misguided. President Clinton and the

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[31] The lags were long and variable because of new fiscal and regulatory obstacles to adjustment, sluggish labor market responses, and the Fed's tight money policy of 1987-91.

Democrats got precisely what they asked from the Fed -- one more year of very loose monetary policy -- in an ill-fated effort to mitigate the damage from last year's tax and budget bill. Monetary policy has disguised and delayed the economic damage of ill-conceived fiscal and regulatory policy, but **monetary policy cannot compensate for nor prevent the damage.**

We may be experiencing a classic instance of what happens when monetary policy attempts to offset policy mistakes on the fiscal and regulatory front -- "accommodating monetary policy" in the political jargon. Inevitably, too much money is created, the economy is artificially boosted for a short period, and eventually the economy slows or even tumbles into a recession, all with higher inflation.

Now the Fed faces a dilemma. Long-term interest rates have been rising. In order to keep short-term rates at the same low levels at which they have persisted for the past two years, the Fed would have to loosen monetary policy even more, that is, the Fed would be forced to inject more reserves into the banking system by buying up more Federal securities to keep short-term rates down. Instead, the Fed has begun to allow short-term rates to rise.

If the Fed mistakenly believes it must slow the economy to control inflation, it may do the right thing (decelerate money growth) for the wrong reason (to slow the economy) and end up doing the wrong thing (over-playing its hand and slowing the economy more than necessary). If, on the other hand, the Fed does the right thing for the right reason, i.e., merely attempts to gradually decelerate money growth to a noninflationary rate, the economy will approach its own growth rate without diving too far or crashing. Admittedly, growth capacity is depressed by the 1990s tax and regulatory follies. We might see the economy settle back to 2.5 percent real growth with inflation in the 2 to 3 percent range.

The Long-Run Outlook

A weak increase in investment during the current two-thirds expansion and continuing policy errors raise the question of the long-run prospect for improvement in U.S. standards of living. Over the long run, productivity is nearly everything. And nothing is more important to long-run success than the tax, spending and regulatory/ legal framework.[32]

The long-run decline in net investment clearly threatens productivity growth and job creation. The budget bill passed in August 1993 raised tax rates on high-income individuals, and the top 1 percent of income earners derive 60 percent of their income

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[32] Monetary policy is vital in the short run while monetary institutions are vital in the long run. An unstable monetary framework based on fiat paper money, currently the Greenspan dollar, remains a permanent drag on investment and growth because people have less confidence in the future value of money. The result is higher interest rates and permanently lower rates of investment. The gold standard.

from investments. According to recent estimates, after the Clinton tax increases take full effect, the marginal tax rate on capital will equal 60 percent, an all time high. The marginal tax rate on labor is now 45 percent, also an all time high.[33]

The immediate effect of higher taxes on investment income is to lower the return to investment. Historically, individuals have reacted to diminished after-tax return on investment by reducing investment, which has the ultimate effect of raising the before-tax rate of return on investment at lower overall levels of investment and thereby restoring the earlier after-tax rate of return. As a rule, individuals have continued to reduce their levels of investment up to the point at which the real post-tax rate of return on investment rises back to 3.3 percent.[34] Conversely, a 10 percent tax reduction on investment income costs government about $10 billion a year in direct revenue lost but stimulates a 5 percent increase in the capital stock, a $120 billion increase in all government revenues and a $120 billion gain in post-tax income for wage earners.[35]

Administration economists inadvertently admit the deleterious impact of their tax increase on saving and investment. According to them, the increased tax payments in 1994 "will have a smaller effect on GDP than the extra payments made in 1993 by taxpayers" because "high-income taxpayers are presumably more likely to make the payments out of savings."[36] But if the higher taxes come at the expense of savings, then savings and investment must fall, all else equal.

The Clinton economists also predict that the investment share of GDP will rise one percentage point within three years based on the claim that higher taxes will finance reductions in the Federal deficit. But this theory is grossly defective on a number of grounds. Higher tax rates do not reduce Federal deficits because, first, the effect of the economy on the deficit is enormous compared to the deficit's effect on the economy. Administration economists have cause and effect reversed. Second, taxes are not too low, Federal spending is too high. Third, higher rates on high income individuals never collect the anticipated revenue because high-income individuals are not idiots. Fourth,

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[33] Robbins, Aldona and Gary Robbins, "Why Bush Lost the Election: Ten Lessons for the Clinton Administration," National Center for Policy Analysis Media Backgrounder No. 124, January 7, 1993, and telephone conversation with the authors, March 17, 1994.

[34] Robbins, Aldona and Gary Robbins, *Capital, Taxes and Growth*, National Center for Policy Analysis, NCPA Policy Report No. 169, January 1992.

[35] *Ibid.*, *Why Bush Lost the Election: Ten Lessons for the Clinton Administration*, Media Backgrounder No. 124, National Center for Policy Analysis, January 7, 1993, pg. 10.

[36] *Economic Report of the President*, February 1994, pp. 74-75.

any dollar in new tax revenues triggers $1.59 in spending.[37] And contrary to the *Economic Report of the President*, marginal tax rates matter. Higher taxes on labor and capital raise production costs, reduce returns to economic activity and inevitably cause production and employment cutbacks.

Economists outside the Administration recognize that government taxing and spending brakes business growth. For example, Gerald Scully finds that a 10 percentage point increase in government expenditures as a share of GDP cuts the annual economic growth rate by one full percentage point.[38] Scully also finds that taxation above the 21.5 to 22.9 percent that prevailed in the United States in 1949 has cost Americans $30 trillion (in 1972 dollars) in lost output over 40 years, or 15 times the actual output produced in 1989.[39] U.S. output and household incomes are 40 percent lower than they would have been in 1989 had tax rates remained at 1949 levels. Such a growth tax also implies that governments collected $3.7 trillion less in taxes, more than the entire public debt among all levels of government in 1989. The actual growth rate of real GDP 1949-89 was 3.5 percent instead of the 5.6 percent that would have occurred at 1949 tax rates.

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. Over the long run, economic forecasts tend to converge toward an annual real growth rate of about 2.5 percent. CBO, for example, targets real growth in the years 2000 and beyond at 2.3 percent. The long-run *Blue Chip* Consensus puts real growth at 2.6 percent a year.[40] According to President Clinton's Council of Economic Advisers, long-run growth potential is "a little below 2.5 percent."[41]

There is a general consensus that economic output will tend to fluctuate around a growth path that would be traced out if the economy experienced a constant 2.5 percent

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[37] Vedder, Richard, Lowell Gallaway, and Christopher Frenze, *Taxes and Deficits: New Evidence (The $1.59 Study)*, JEC/GOP staff report, October 31, 1991; Christopher Frenze, *Taxing the Way to More Deficit Spending*, JEC/GOP staff report, June 1993; Alvin Rabushka, *Ten Myths about Deficit Spending*, Hoover Institution, 1993.

[38] Scully, Gerald, "The Size of the State, Economic Growth and the Efficient Utilization of National Resources," *Public Choice*, 63, 1989, pp. 149-164, and Gerald Scully, "Statism versus Individualism and Economic Progress in Latin America," in John C. Goodman and Ramona Marotz-Baden, editors, *Fighting The War of Ideas in Latin America*, Dallas, Texas: National Center for Policy Analysis, 1990, pp. 200-226.

[39] Scully, Gerald W., "What is the Optimal Size of Government in the United States?," National Center for Policy Analysis, Dallas, TX, Working Paper, January 1994, and Gerald W. Scully, "The Growth Tax in the United States," *Public Choice*, in press, and E.A. Peden and M.D. Bradley, "Government Size, Productivity, and Economic Growth: The Post-War Experience," *Public Choice*, 61, 1989, pp. 229-245.

[40] *Blue Chip Economic Indicators*, March 10, 1994, pg. 11.

[41] *Economic Report of the President*, Council of Economic Advisers, February 1994, pg. 87.

rate of real growth. Consequently, whenever the economy is rising at a rate greater than 2.5 percent, economists expect growth eventually to decline to bring the economy back to its sustainable, long-run path.

This situation contrasts starkly with U.S. economic history. Table I.3 shows that the real output tended to grow at nearly 4 percent per year between 1889 and 1973, if we exclude the Great Depression caused by the colossal blunders of Washington, D.C. Labor productivity increased at average annual rates between 2 and 3 percent between 1889 and 1973.

Table I.3 — **Real Gross Product, Inputs, and Productivity Ratios for the U.S. Business Economy, 1800-1993**
(average annual rates of change)

	1800-1855	**1855-1890**	**1889-1919**	**1919-1948**	**1948-1973**	**1973-1981**	**1981-1992**
Real Gross Output	4.2%	4.0%	3.9%	3.0%	3.7%	2.2%	2.4%
Population	3.1	2.4	1.8	1.2	1.5	0.8	1.0
Real Output per Capita	1.1	1.6	2.1	1.8	2.2	1.4	1.4
Labor Productivity	0.5	1.1	2.0	2.4	3.0	0.8	1.1
Total Factor Productivity	0.3	0.3	1.7	2.2	2.0	0.1	0.9*

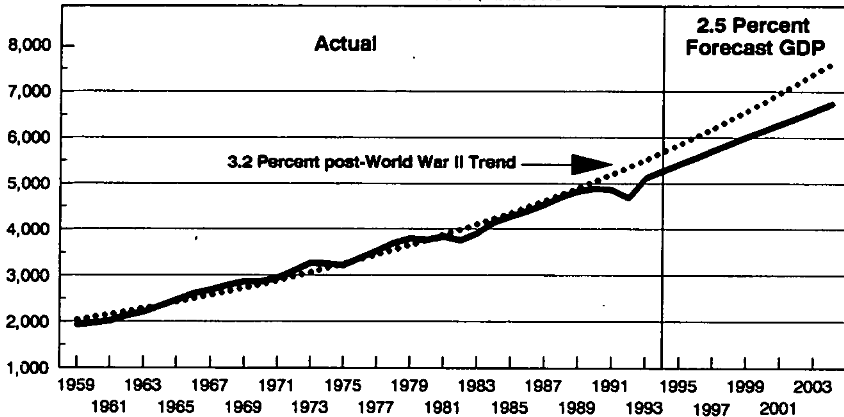
Sources: 1800-1948, John W. Kendrick, *Improving Company Productivity*, (Baltimore: Johns Hopkins University Press, 1984), pg. 87; 1948-81, John Kendrick, *The Cato Journal*, 4 (Fall 1984), pg. 389; 1981-92, calculated from *Economic Report of the President, January 1994, and Economic Indicators, March 1994.*

* Calculated from *Monthly Labor Review*, June 1993, pg. 111, refers to years 1981-90.

Although the change in real GDP from any one year to the next may be considerably above or below growth potential, growth in 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. Now, however, we have been condemned to a consensus long-term forecast of "two-something" growth rates. Between 1992 and 2005, the labor force is expected to grow at a 1.3 percent annual rate. If real output only grows at 2.3 to 2.5 annual rates, then productivity only increases at 1.0-1.2 annual rates. While this may be a "realistic" scenario -- and probably is given the continued anti-growth tax regulatory policy coming out of Washington -- this forecast assumes the same low rates of productivity improvement that have prevailed since the early 1970s. This anemic economic outlook stands in stark contrast to the Clinton/Democrat rhetoric of "robust economic growth to come."

If the consensus forecast is correct, the level of GDP, a proxy for our standard of living, will continue to fall further and further below the century-old trend, creating a "growth gap" between actual economic performance and historical precedent. This situation is depicted in Chart I.1.

Chart I.1



Source: CBO and JEC/GOP staff calculations.

An economy trapped on this lower level growth path has serious negative consequences for the future prosperity of America. A two-something growth rate will not satisfy the public's expectations, nor should it. The economic slowdown, which began in 1989 and continued into 1991, coupled with an anemic recovery, has left the nation in a deep economic trench. Continued slow growth promises to make the task of digging back out very difficult. As the chart 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 historic potential.

It will take growth in excess of 4 percent a year for several years to get back to trend. This is not an unreasonable economic policy goal. Thus, the near-term goal of economic policy making should be to improve the performance of the economy sufficiently to close the growth gap. The long-run national economic objective should be, at a minimum, to restore the economy to the average level of performance it had maintained, since the end of World War II and ultimately back at the same level of performance it had maintained for a century prior to 1989. Only this will keep the growth gap from reemerging, and only policy impediments devised in Washington prevent restoration of the historical trend from occurring.

How can productivity be boosted? A productive civil society requires the role of law; policies and habits that promote the formation and preservation of families; avoidance of self-destructive personal behavior and its social pathologies; and an educational system committed to excellence and discipline. These go hand in hand with the free market's incentives for creativity.

In economic terms, productivity will rise when there is an institutional framework which encourages capital investment, skilled and well-motivated workers, more invention and technological progress, more entrepreneurship, and improved coordination in order to continually reallocate capital and labor into their most valuable uses. Capitalists, ultimately, are workers' best friends because investment is the lifeblood of economic progress. And economic growth is the only lasting method to reduce poverty and income inequality. There are no shortcuts. The Federal Reserve printing press cannot do it.

The institutional framework for achieving these aims is also well known. As Adam Smith wrote: "Little else is requisite to carry a state to the highest degree of opulence from the lowest barbarism, but peace, easy taxes and a tolerable administration of justice; all the rest being brought about by the natural course of things."[42] Our economic difficulties stem from violating Smith's rules, especially on taxation, a broad term for the many barriers to progress that government erects. Government cannot deliver the goods, only free markets can.

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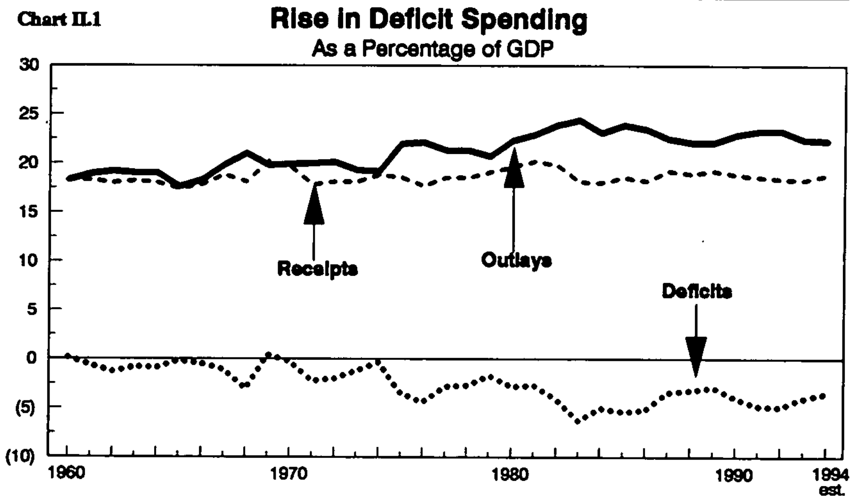
[42] Cited by E.G. West, *Adam Smith: The Man and His Works*, Indianapolis: Liberty Press, 1976, pg. 58.

II

TAXES AND SPENDING

The Federal budget, as an instrument of government policy, reflects the outcome of decisions made in the political process. These decisions are primarily made by Congress in accordance with the power of the purse provided in the Constitution; taxes and spending cannot be raised without congressional action. Congressional debate over taxes and spending reflects major philosophical differences concerning what government properly can and should do. The budget data cannot resolve these philosophical differences, but can help ensure that these debates are framed in accordance with the facts.

Expressed as a share of gross domestic product, revenues have remained fairly stable for over three decades. The revenue share of GDP has oscillated at around 18 to 19 percent for most of the postwar period, and is currently projected at the high end of this range. Since 1960, when revenues and outlays were nearly equal, the outlay share of GDP has trended upward. This rise in outlays explains the increase in deficit spending over this 34-year time span, as shown in Chart II.1:



Source: *Budget Baselines, Historical Data, January 1994,* Executive Office of the President, OMB.

The contrast revealed in the chart is between the stability of the revenue share of GDP and the inexorable rise of outlays. The outlay share of 22.3 percent projected for current fiscal year 1994 is far above the postwar average. **The increase in the outlay percentage of GDP relative to the 1946-60 average accounts for all of the deficit.**

Nonetheless, some have argued that a shortfall in revenue has led to the high deficits over the last decade. However, in nominal terms, revenues climbed by half a trillion dollars during the 1980s, while remaining in their postwar range as a percentage of GDP. Viewed in the context of the postwar period, the trend is clearly toward higher spending, not declining revenues.

Unless voters demand change at the polls, the probability of a decline in the outlay share of GDP during the 1990s is low given the direction of current policies. Instead, the addition of trillions of dollars in new spending for health care reform and other spending initiatives likely will push the outlay and deficit share of GDP to new highs.

It is interesting to recall the controversy over defense "burden sharing" in the last decade in which the economic performance of the United States was argued to have been undermined by the higher costs of U.S. defenses. However, what has happened is that this burden has been converted from defense to domestic spending, but still represents a drag on the U.S. economy. The magnitude of this shift is enormous, with about $100 billion real (inflation adjusted) reduction in annual defense spending projected between 1989 and 1997, even as the total budget continues to grow. Instead of being returned to the taxpayers, this money has been converted into domestic spending increases.

Thus, an average of at least $70 billion per year in defense cuts that could have been devoted to deficit reduction or more productively to tax cuts on saving and investment, was spent on domestic programs.

Recent Budget Projections

A review of CBO budget projections shows how perceptions of the deficit have changed in recent years: **Deficits of a size deemed ruinous in the first two years of the Bush Administration are now exceeded greatly by the Clinton Administration, and nonetheless touted as a great success.**

Table II.1 contains the CBO projection of the budget totals produced in January 1990, which were considered dangerous enough to justify convening a budget summit and President Bush breaking his no-new taxes pledge in 1990.

Table II.1 — 1990 CBO Budget Projections
(in $-billions)

	1989	1990	1991	1992	1993	1994	1995
Total Revenues	991	1,067	1,137	1,204	1,277	1,355	1,438
Outlays	1,143	1,205	1,275	1,339	1,418	1,484	1,555
Deficit	152	138	138	135	141	130	118

Source: CBO.

As Table II.1 indicates, CBO projected that the deficit would fluctuate between $130 and $141 billion between fiscal 1990 and 1994, falling to $118 billion in 1995. In these years revenues were projected to grow an average of $75 billion or 6.4 percent annually, while outlays were expected to climb $69 billion annually. This scenario would seem benign by current standards but it sparked a full blown deficit crisis in 1990. Consequently, a large tax increase was enacted as a major component of the 1990 budget agreement.

In December 1990, after the tax increase was enacted, a CBO assessment of the 1990 budget deal projected that the deficit would gradually decline to a level of $29 billion by fiscal 1995. In reality, deficit spending climbed in the early 1990s.

In August 1991, CBO projected that despite the tax increase, the deficit would grow to $278 billion in 1993, $234 in 1994, and $157 in 1995. In 1992, CBO projected a 1992 deficit of $368 billion, $78 billion more than the actual 1992 deficit turned out to be. Incredibly, by August 1992 CBO had adjusted its estimate of the 1993 deficit up to $331 billion. The August 1992 upward revision in projected future deficits was used after the 1992 election by then President-elect Clinton to justify reneging on his promised middle class tax cut, even though the CBO revision had been released several months before the election.

The $331 billion CBO projection for fiscal 1993 was reduced sharply in January of 1993 with a $45 billion downward revision in deposit insurance outlays, and again in September of 1993 with another $29 billion adjustment in deposit insurance outlays. These deposit insurance revisions were partially offset by increases elsewhere but reduced the deficit by $74 billion relative to what it otherwise would have been.

Including deposit insurance, the deficit was actually $290 billion in 1992 and $255 billion in 1993. Of the $35 billion reduction in 1993, $31 billion was accounted for by a swing in actual deposit insurance outlays. Though the 1993 Clinton budget proposal had actually proposed increasing the 1993 deficit through the stimulus package, its defeat meant the Clinton Administration had virtually no effect on the deficit for 1993. Excluding the effects of deposit insurance, the deficit was $287 billion in 1992, and $283 billion in 1993, a trivial reduction.

The exaggerated earlier projections of unrealistically huge deficits in 1992 and 1993, based largely on unpredictable deposit insurance outlays, created the impression that enormous progress had been made in reducing the deficit in 1993. In Winter 1992, CBO had projected a 1992 deficit of $368 billion, reflecting $63 billion in deposit insurance outlays that actually were never made, while inflows from deposit insurance outlays ended up reducing the deficit by $28 billion in 1993. **Thus an apparent deficit reduction of about $90 billion between January 1992 and the end of fiscal 1993 is accounted for by changes in projected versus actual deposit insurance outlays in 1992 and 1993, not the Clinton budget.**

The CBO budget deficit projections had showed a sharp deterioration soon after the 1990 budget deal for a variety of economic and technical factors. One major problem was CBO's failure to heed the warnings of JEC Republican (GOP) studies[1] which had showed as early as 1991 that the agency's capital gains estimates were unduly optimistic; this CBO error exaggerated projected income tax revenues by as much as $43 billion annually. Another problem was the effects of the recession aided and abetted by the 1990 budget deal. As discussed, deposit insurance outlays also clouded the picture, and were impossible to estimate accurately. In any event, the budget deal's promise of deep deficit reductions failed to materialize. In 1990 before the budget deal was enacted, the projected 1993 deficit was $141 billion and decried by the Bush Administration and congressional Democrats as ruinous. The actual deficit for 1993, the first year of the Clinton presidency, came in at $255 billion and was hailed as a great success.

THE CLINTON BUDGET: POLICY OR PROPAGANDA?

The President and members of his cabinet not only depict the 1993 deficit as a great improvement, they also take credit for that improvement by claiming that the huge Clinton tax increase boosted economic growth and sharply reduced the budget deficit. According to this argument, the continued decline of interest rates in 1993 was caused by the Clinton program, which in turn stimulated the economy in 1993 and helped bring the budget deficit down. The Administration contends further that the combined effect of continued strong economic growth and higher revenues from the tax increases will reduce the deficit to $176 billion in 1995 and $173 billion in 1996.

The Clinton budget also claims that 1995 will be the first time since Truman "with 3 years of consecutive deficit declines." However, the Clinton deficit reductions are only projections, and this is far from the first time in memory that three consecutive declines in the deficit have been **projected**. In fact, according to CBO projections, deficits were projected to decline in three consecutive years as recently as during the Bush Administration.

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[1] See JEC/GOP study, *Distorting the Data Base: CBO and the Politics of Income Redistribution*, prepared at the request of Representative Dick Armey (R-TX), Joint Economic Committee, April 1991.

It will be recalled how unreliable deficit projections have been in the past, typically growing over time, often by enormous amounts. For example, soon after the 1990 tax increase, CBO forecast that the 1995 deficit would be only $29 billion. Now, two huge tax increases later, a deficit five times larger is being heralded as a major accomplishment. A variety of errors in economic, revenue, and outlay assumptions can plausibly be offered to explain erroneous deficit projections, but these are erroneous just the same. The key point is that budget projections that refer to fiscal years ending more than one year in the future are quite unreliable, and cannot be compared with actual budget data.

The current deficit projections seem favorable relative to the early 1990s, but they are not especially impressive compared to the late 1980s. In the last three Reagan budget years, deficit spending amounted to $149.8 billion in 1987, $155.2 billion in 1988, and $152.5 billion in 1989. The Clinton Administration will not be able to lower the level of deficit spending anywhere near the level reached upon the completion of the Reagan program, especially if admitted defense, welfare, and health costs are taken into account.

Unfortunately, the Clinton Administration's budget policy resembles that crafted by Richard Darman and congressional Democrats in 1990. The result was the highest level of deficit spending on record. Over the next several years it will become clear whether the 1993 Clinton budget policies will have better results on the long-term deficit problem than did the 1990 budget agreement. Americas voted for change in 1992, but it appears they got more of the same -- higher taxes, more spending and larger deficits.

The number of those affected directly and indirectly by the Clinton tax program is much larger than generally realized. As pointed out in a JEC/GOP report last year[2], the Administration's definition of income used to classify those affected by the tax makes these taxpayers appear to have higher incomes than they actually do. Moreover, two thirds of the taxpayers with taxable incomes affected by the increases in the income tax rates are small business owners, and tax increases falling on them will not only undermine their business operations, but also their ability to expand employment. In addition, the increased taxation of middle income social security beneficiaries will affect millions of addition taxpayers. Finally, the regressive gas tax will increase taxes on low income taxpayers, many of whom will not qualify for items calculated as offsets to the tax.

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[2] A JEC/GOP staff report, *Taxing the Rich? Economic Policy Update*, March 5, 1993

ECONOMIC ASSUMPTIONS

Recent quarterly increases in real GDP show improvement, but these must be placed in historical context. It is certainly true that the economy accelerated strongly in the second half of 1993, but this improvement is marked especially in comparison to the dismal first half of 1993. Real GNP growth in 1992 was higher than in 1993 in the first three quarters, and lower only in the last quarter. Consequently, on a fourth quarter to fourth quarter basis typically used in economic and budget analysis, real economic growth actually decelerated from a 3.9 percent rate in 1992 to 3.1 percent in 1993. It is ironic that the Clinton Administration has gone from questioning the accuracy of positive GDP data late in 1992 to now taking credit for the economic upswing which these data first reflected.[3]

The economic assumptions in the budget are displayed in Table II.2. Essentially, the economy is to projected to grow at a rate below the postwar average for the next several years.

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[3] "The Transition: The President-Elect; Despite Some Signs of Recovery, Clinton Points to Economic Perils," *The New York Times*, November 10, 1993.

Table II.2 — **Economic Assumptions**[1]
(in $-billions)

	Projections						
	1993	**1994**	**1995**	**1996**	**1997**	**1998**	**1999**
Gross Domestic Product:							
Levels, dollar amounts in billions:							
Constant (1987) dollars	5,126	5,284	5,433	5,579	5,725	5,873	6,021
Percent change, fourth quarter over fourth quarter:							
Constant (1987) dollars	2.3	3.0	2.7	2.7	2.6	2.6	2.5
Consumer Price Index (all urban):[2]							
Percent change, fourth quarter over fourth quarter	2.8	3.0	3.2	3.3	3.4	3.4	3.4
Unemployment rate, civilian, percent:[3]							
Annual average	6.8	6.5	6.1	5.9	5.7	5.5	5.5
Interest rates, percent:							
91-day Treasury bills[4]	3.0	3.4	3.8	4.1	4.4	4.4	4.4
10-year Treasury notes	5.9	5.8	5.8	5.8	5.8	5.8	5.8

Source: *Budget of the United States Government, Analytical Perspectives, Fiscal Year 1995*, pg. 4.

[1]Based on information available as of December 1993.
[2]CPI for all urban consumers.
[3]Pre-1994 basis. The introduction of a new labor force questionnaire in January 1994 may result in higher unemployment rates than these shown in the table.
[4]Average rate (bank discount basis) on new issues within period.

Interest rates did decline in 1993, as they had in 1992, 1991, and 1990. Interest rates should be expected to decline in a period of protracted disinflation, a process that had been well underway since the mid-1980s. However, it appears certain that interest rates will be higher in the foreseeable future. To the extent low interest rates are responsible for the quickening of the economy in recent quarters, higher interest rates in the future may slow growth. Alan Blinder, a member of the President's Council of Economic Advisers, has conceded the fact that market interest rates already exceed Administration assumptions for 1994: "This has caught us by surprise just as it has caught most people by surprise."[4] If interest rates in 1994 and 1995 were only one percentage point higher than the Administration assumes, deficit spending would rise $13.4 billion in fiscal 1995. A rise of two percentage points relative to the forecast would raise the 1995 deficit by $26.8 billion.

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[4] "As Market Pressures Build, Fed Chief Goes to Congress," *The New York Times*, February 22, 1994.

The Administration projects real GDP growth at 3.0 percent for 1994, 2.7 percent for 1995 and 1996, and 2.6 percent for 1997 and 1998. The Administration forecast assumes smooth sailing for the economy through 1997, meaning an economic expansion more than twice as long as the postwar average. Needless to say, any unexpected weakness in economic growth will significantly change the budget estimates for the worse. Each one percentage point reduction in GDP growth in a given year would add up to $30 billion to deficit spending in the out-years. Any recession in 1994, 1995, 1996 or 1997 would dramatically increase projected deficit spending. A swing from 2.5 percent growth to 2 percent decline in GDP could add as much as $135 billion annually to the outyear budget deficits.

SLOW REVENUE GROWTH SHOWS FUTILITY OF TAX INCREASES

A review of the Clinton budget raises questions about the Administration's reliance upon tax increases. The effectiveness of raising taxes in producing revenue can be tested by a comparison of revenue growth before and after legislated tax increases take effect. If the average annual increase in revenues rises above the baseline by the amount projected in tax increase legislation, it can be argued to have had the intended effects. If, on the other hand, the revenue does not rise by the estimated amount of the tax increase, assuming similar nominal GDP growth, then the policy of tax increases has failed. An examination of the Office of Management and Budget (OMB) revenue projection is the first step in considering this question. The Administration's tax, spending, and deficit projections for fiscal 1994-99 are presented below in Table II.3.

Table II.3 — **Outlays, Receipts and Deficit Summary**
(in $-billions)

	1993	1994	1995	1996	1997	1998	1999
Total Outlays	1,408.2	1,484.0	1,518.3	1,583.5	1,660.3	1,738.2	1,830.2
Receipts	1,153.5	1,249.2	1,342.2	1,410.4	1,479.5	1,550.8	1,629.0
Deficit	254.7	234.8	176.1	173.1	180.8	187.4	201.2

Source: *Budget of United States Government, Fiscal Year 1995*, pg. 13.

Revenues are projected to grow $475.5 billion, or an average of $79 billion annually, in fiscal year 1994 through 1999, while projected outlays rise $422 billion, an average of $70.3 billion each year. The budget deficit is projected to bottom out in 1996, and trend upward thereafter. The projected changes in revenues must be examined carefully before concluding that a strategy of tax increases has been proven effective. This can be done by comparing baseline increases in revenues estimated in 1989 or 1990, and comparing them to revenue increases projected now that two major tax increases have gone into effect.

Table II.1 and accompanying text present the 1990 CBO budget projections and trend in revenues and outlays. Before either the 1990 or 1993 tax increase legislation, the CBO baseline projected that revenues would increase 6.4 percent annually, or by $74.5 billion a year, for $447 billion in fiscal 1990-95. By 1995, revenues were projected to rise by $83 billion annually. After the largest tax increases in U.S. history, the Clinton Administration projects that annual revenue growth will slow to a rate of 5.9 percent, yielding an average annual revenue increase almost identical to that projected under 1989 tax law. In other words, the largest tax bills ever failed to increase the pace of revenue growth over the baseline projected in 1989 and 1990 before enactment of either tax bill. If recession year 1991 is used as a base year, the annual rate of revenue growth is only 5.6 percent through 1999.

Table II.4 — **Projected Annual Average Revenue Growth**
(in $-billions)

1989 CBO Baseline (Fiscal 1989-94)	$75
1990 CBO Baseline (Fiscal 1990-95)	$75
1994 OMB Projection (Fiscal 1994-99)	$79

Source: CBO and OMB.

The projected revenue growth from the 1990 and 1993 tax bills has apparently disappeared. Addition of the $158 billion of new taxes over five years enacted in 1990, and the $241 billion enacted in 1993, should be evident in the revenue data. Instead, even according to the Administration's own estimates, **annual average revenue growth is now projected to be almost identical to that projected in 1989 and 1990 before either the 1990 or 1993 tax increase was enacted.** The amount of revenue growth in the final year of the forecast is now actually below that projected in 1990.

The nearly identical annual average revenue growth projected under 1989 and 1994 tax law is not caused by a reduction in annual growth of nominal output. In the 1990-95 period nominal output was estimated to rise an average of $385 billion a year, while in the fiscal 1994-99 period it is projected to increase $416.5 billion annually. The higher growth in the amount of nominal output in the later period is rooted in a higher base, and implies at least $5 billion of additional revenue annually, explaining most of the slightly higher annual revenue increase of $79 billion.

The total failure of the two major tax increases to raise baseline revenue growth shows the futility of the tax-increase policy to reduce the budget deficit. Taxpayer behavior has changed in recent years to avoid exposure to the higher effective tax rates. As pointed out in the previous chapter, the evidence demonstrates that taxpayers do respond to changes in effective tax rates by adjusting their realization of taxable income. Congress has been misled into a view that legislated tax increases and statutory rate hikes would raise revenues relative to what they would otherwise be but there is no evidence for this contention in the revenue data.

As *The Economist* has pointed out, "High tax rates on big incomes may seem fair. But they waste economic resources -- and may not even raise much money."[5] This article, appropriately entitled "A Marginal Error," also pointed out how taxpayers can adjust their realization of taxable income to avoid tax increases, based on a recent NBER study by Martin Feldstein. According to a calculation by Feldstein, only $3.4 billion of the nearly $30 billion in extra revenues from high income earners projected under the Clinton tax increase may actually materialize.

Furthermore, the underlying premise of the Administration's tax program -- that the rich paid less income tax after 1981 -- is simply false. As discussed in Chapter IV, the average and aggregate income tax payments of the top 1 percent increased sharply during the 1980s. Moreover, the latest Internal Revenue Service (IRS) data show that after the 1990 tax rate increase, a fall in revenue collections from upper income taxpayers produced an actual decline in total personal income tax revenues in 1991.

Clearly the failure of tax increases to raise trend revenue growth above baseline levels raises doubts about the accuracy of revenue forecasts. CBO and OMB have informed Congress that adoption of major tax increases would raise revenue significantly above the baseline levels, and this additional revenue has failed to materialize. Instead, it appears that we have been taxing America into higher deficits. **Each dollar of tax increase enacted in 1990 and 1993 has led to a $0.71 increase in the deficit for 1995** (Chart II.2).

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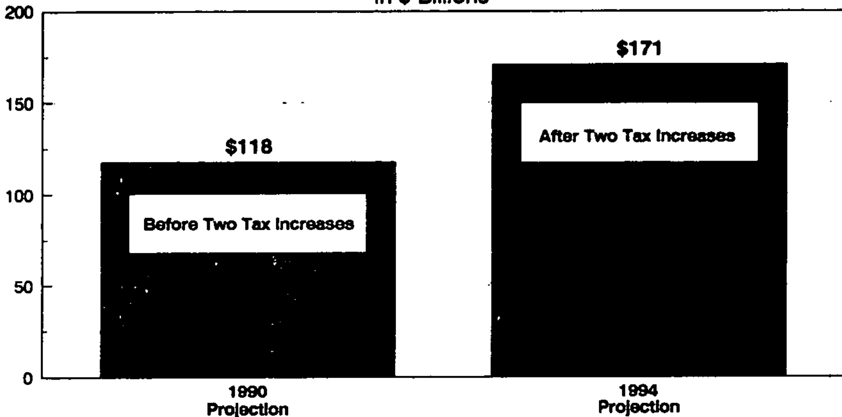
[5] *The Economist*, April 1, 1994, pg. 68.

Chart II.2



Source: CBO and JEC/GOP staff calculations.

The deficit projections depend in part on the accuracy of Administration revenue estimates. The factual record with respect to revenue estimates suggests that taxpayers will adjust their realization of taxable income to minimize their exposure to the new higher tax regime. While the extent of this flexibility has been under-estimated in the past, revenue forecasting still resists acknowledging the importance of this adjustment. Despite the relatively low revenue growth projected by OMB and CBO in coming years, it is likely that even this will prove optimistic. To date, personal income tax revenues in fiscal 1994 are actually lagging behind the pace set by other Federal tax revenues. According to Fidelity Investments President, Edward Johnson, "a recent survey of 500 U.S. households, conducted by Fidelity and Yankelovich Partners, showed that few people have taken steps to reduce their taxes under the new legislation. Many were not even aware that the new tax laws were retroactive to January 1993."[6] In any event, given the modest growth in revenues projected, any unexpected and significant increase in the trend of outlay growth will quickly worsen the deficit outlook.

OPTIMISTIC POLICY OUTLOOK

Excluding deposit insurance, the 1995 deficit is projected by OMB to be $187 billion. The proceeds of the savings and loan clean-up reduce both total outlays and the deficit by $11 billion in 1995. While these amounts are not huge in the context of a $1.5

[6] Johnson III, Edward C., *Fidelity Contrafund Annual Report*, 1994, pg. 3.

trillion budget, deposit insurance proceeds do make the amount of deficit spending appear smaller than it really is.

Even so, according to Administration projections, Federal spending will increase $346 billion in fiscal 1995-99. The average annual growth of spending of $69 billion projected in fiscal 1995-99 translates into a 4.3 percent compound average growth rate for the period. This growth rate will not be easily attainable from significant real reductions in defense, which have held down overall spending growth in past years.

Only by assuming that 1995 spending growth is half of its trend can the deficit be reduced to the level projected in 1995. However, accounting for only $14 billion of unbudgeted spending for Administration initiatives would take the deficit, excluding deposit insurance, back over the $200 billion mark. The Administration deficit projection for 1995 is precarious because it ignores new spending requested by the Administration, and relies on dubious accounting and economic assumptions. The current level of long-term interest rates is already above that forecast by the Administration, and this will add to Federal spending for fiscal 1994 and following years.

One real policy accomplishment contributing to restraint of deficit spending was the blockage of the stimulus package by Senate Republicans in 1993. This not only saved $17 billion in additional deficit spending requested by the President, but also silenced calls for much larger stimulus bills promoted by liberal economists and members of Congress. Another positive result of the defeat of the stimulus package was that it forced the Administration to drop most of its $144 billion in "investment" deficit spending between 1994 and 1998. All told, about $150 billion in deficit spending requested by President Clinton was stopped, significantly improving the deficit outlook. In 1995 alone, the level of deficit spending would have been $22 billion higher had not this spending been stopped by actions in Congress. The failure of Clinton spending policy, not its success, will significantly reduce deficit spending in coming years.

The contention that the Clinton budget policy is a success is premature for other policy reasons as well. Under Clinton policy, defense outlays fall in real terms $20.4 billion between fiscal 1993 and fiscal 1995. However, the proposed level of defense spending is at least $20 billion too low over five years to be compatible with Clinton defense policy, and could be much higher. According to Defense Secretary Perry, "We don't have a specific plan to deal with that $20 billion shortfall."[7] Furthermore, the Clinton defense savings assume that no international incident forces an increase in defense spending. By 1996 defense spending as a share of GDP would be at its lowest level since World War II.

Though it is possible to argue that the world is entering a new era of international peace and tranquility permitting such a relaxation of defense spending, events in Central

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[7] *The Christian Science Monitor*, February 4, 1994.

Europe, Russia, and Asia seem to contradict this view. History demonstrates that excessive reductions in defense expenditures are usually followed by defense increases. In sum, the Administration itself now concedes that its defense request is too low, and the direction of world events suggests that emergency and other defense spending increases in the near future are probable.

The Clinton budget does not reflect Administration calls for domestic initiatives in the areas of health, welfare, and crime. For example, the funds provided in the budget are inadequate to pay for the new police called for, and apparently these costs are shifted to the states or localities over time.

In summary, one major reason the Clinton Administration is able to project falling deficits is that the Administration's major domestic initiatives simply are excluded from the budget totals. Emergency spending for natural disasters is also omitted, though the need for funding was known when the budget was submitted. While it would probably be prudent to set aside money for unforeseeable future disasters, this kind of contingency is yet another reason why comparisons of budget projections and final budget data are not comparable.

JEC/GOP Members consider the $422 billion in increased fiscal 1994-99 Federal spending requested by the Administration to be excessive. Unfortunately, the Administration and the liberal leadership in Congress have strongly opposed efforts to trim spending growth. Congress should act now to pare least $26 billion, and preferably more, from spending growth over the next several years. For the foreseeable future, the entire budget will need to be repeatedly scrutinized for additional savings. In addition, institutional reforms such as supermajority voting for increases in Federal spending, would promote fiscal restraint.

Health Reform

Health reform merits special attention when assessing the plausibility of the Administration's projected declines in the budget deficit. The Clinton proposal, the largest entitlement program and tax increase in U.S. history, is scored off-budget by the Administration. Instead of saving $53 billion in the last half of the 1990s as the Administration contends, CBO estimates that the Clinton plan will add $74 billion to deficit spending in fiscal years 1996-99.

The CBO cost estimates of the Clinton plan blithely accepts the Administration's contention that government spending controls will be 100 percent effective. However, CBO's past record of estimating the costs of health reform does not inspire confidence in the accuracy of CBO health care cost estimates. In 1988, Congress enacted a Catastrophic Coverage Act of 1988 on the basis of a CBO estimate that the programs costs would be covered by projected revenues. Unfortunately, as CBO admitted a year later, actual program costs were 31 percent higher than CBO had estimated, exceeding available revenues. If a mistake of this magnitude was made in evaluating a relatively

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small new health program, the potential for error in a much larger and more complicated proposal are enormous. In this case, a 31 percent cost overrun would translate into over $300 billion in additional spending annually.

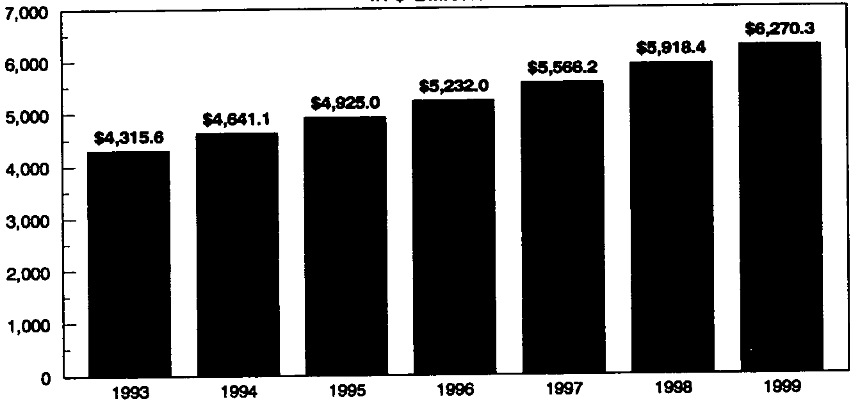
An average shortfall in this vicinity has been forecast by a JEC/GOP analysis released in 1994.[8] By fiscal 1998 and 1999, as much as $294 billion and $361 billion, respectively, could be added to annual budget deficits. This would result in budget deficits well in excess of $500 billion.

A review of the Administration budget and spending proposals shows that the President has requested the largest spending increase in American history. Total Federal outlays would rise by at least 60 percent, with massive increases in deficit spending becoming unavoidable.

National Debt

Under the President's policies, the national debt would jump from $4.3 trillion in 1993 to $6.3 trillion by 1999, an increase of $2 trillion. This increase is one of the largest on record in any five-year period. Chart II.3 displays the rise in the national debt on an annual basis.

Chart II.3



Source: *Budget of the United States Government, Analytical Perspectives, Fiscal Year 1995*, OMB.

[8] JEC/GOP staff report, *A Billion Dollars A Day: The Financing Shortfall in President Clinton's Health Care Proposal*, prepared at the request of Congressman Jim Saxton (R-NJ), Joint Economic Committee, January 1994.

If the Administration's budget or economic assumptions prove optimistic for any of a number of reasons, the projected increases in the national debt would be even larger.

Clinton Administration Policies and Small Business

The increases in the top income tax rate and other taxes under the 1993 Clinton tax increase are assumed to have no negative effects on growth or employment, even though two-thirds of the taxpayers hit by the increase in the top rate are small business owners.

Advocates of higher taxes seem reluctant to accept the fact that a policy of higher personal tax rates on upper income taxpayers will hit small businesses. The Administration attempts to minimize the problem by arguing that affected taxpayers are a small proportion of all small businesses. However, as pointed out in the Republican section of the *1993 Joint Economic Annual Report*, two-thirds of the taxpayers with adjusted gross income (AGI) over $200,000 also participate in partnerships and S corporations.

Moreover, these taxpayers generate the bulk of net income realized by such small business entities. In other words, the taxpayers most directly affected by the Clinton tax increases account for most of the partnerships and S corporation filings and most of the income generated by these small businesses.

Most of the taxpayers affected by the Clinton tax increase are small business owners; it is this fact the Administration is trying to hide with its statistical smoke screen.

Analysis of the IRS Data

The Statistics of Income (SOI) division of the Internal Revenue Service is the major source of detailed income tax data. This analysis will be based on 1990 tax year data published in the *SOI Bulletin*.

Taxpayers with AGI in excess of $200,000 are assumed to have taxable incomes high enough to be affected by the Clinton tax increases. In 1990, there were 849,635 taxpayers with AGI of $200,000 or more. To what extent were they engaged in small business activities?

One test is the proportion of these taxpayers participating in partnerships or S corporations. Partnerships and S corporations are typical forms of small business. In this report, the data on proprietorships, another form of small business, are not mixed with partnership and S corporation data to avoid double counting of taxpayers. As such, the partnership and S corporation information will reflect a lower level of small business activity than if data on proprietorships were also combined. Thus this conservative methodology will tend to understate small business activity among affected taxpayers.

In 1990, 558,204 taxpayers with AGI over $200,000, or 65.7 percent, filed returns with partnership or S corporation net income or losses (See Table II.5). In sum, two-thirds of these taxpayers were involved with these forms of small business. Moreover, 252,836 taxpayers with incomes over $200,000 filed as proprietors, some of whom would also have been in partnerships or S corporations (thus the proprietors cannot be added to the other filings). Nonetheless, at least two-thirds, and almost certainly more, of the taxpayers with AGI over $200,000 are small business owners.

Table II.5 — **Most Taxpayers with Incomes Over $200,000 Are Small Business Owners (1990)**

	Number of Returns Percent
Without Partnership or S Corporation Income (291,431)	34.3%
With Partnership or S Corporation Income (558,204	65.7%
TOTAL (849,635)	100.0%

Source: JEC/GOP staff report, *Taxing Small Business, Economic Policy Update*, July 1993.

Another test of the vulnerability of small business to the Clinton tax increase is the degree of exposure of total small business income in the affected tax brackets. After all, even if a high proportion of these taxpayers were involved in small businesses, this involvement might only reflect a small proportion of total small business income generated by partnerships and S corporations. An examination of the SOI data shows what share of this small business income would be subjected to the Clinton tax increase.

In 1990, partnerships and S corporations reported $104.9 billion of net income on taxable returns. Of this amount, taxpayers with AGI over $200,000 accounted for $69.4 billion, or 66 percent, of this small business income. Taxpayers with AGI over $100,000 accounted for 81.0 percent of partnership and S corporation income.

Clearly, Administration efforts to increase income taxes will subject most partnership and S corporation income to the higher tax rates. The Administration argument that its tax increase policy will have only a minimal effect on small business is contradicted by the fact that so many affected taxpayers are small business owners.

The Administration has made much of the argument that only a fraction of the 20 million small businesses in the United States will be subject to the higher tax rates. However, this 20 million figure is misleading. It appears to double count taxpayers filing as proprietors and as partnership or S corporation owners. However, this would be proper only if these were mutually exclusive categories, which they are not. Furthermore, while most proprietors are full-time enterprises, the Treasury statistic includes part-time businesses conducted only sporadically or temporarily, as opposed to full-time, on-going firms.

In 1990, 2.5 million returns -- more than a fifth of all proprietor returns with net income -- were nontaxable, as opposed to 244,920 partnership and S corporation returns with net income. Moreover, proprietor returns with AGI under $15,000, with an average AGI of only $5,182, accounted for another 31 percent of proprietor returns. The point is that 53 percent of proprietor returns generating net income are either nontaxable or generate very low levels of income. Thus any tax increase affecting taxpayers with taxable incomes above only $8,000 or $10,000 would by definition **not** affect most small business proprietorships. Using the proportion of small business filers as a measure of the Clinton tax increase's effect on small business is misleading for a host of reasons, including the fact that such a high proportion of proprietors generate such low levels of income as to be unaffected by practically any tax increase. In other words, the inclusion of millions of proprietors in the data with incomes so low as to be unaffected by virtually any tax increase says little about the impact of any specific tax increase.

The key issue is the proportion of taxpayers affected by the Clinton tax increase who are also small business owners. An examination of the data shows that this proportion is at least two-thirds, and almost certainly somewhat higher. The Clinton tax increase will hurt small business for the simple reason that at least two-thirds of the affected taxpayers are small business owners. The Administration's methodology in presenting this issue is designed to obscure this crucial fact. The Administration argument relies on the inclusion of millions of proprietors with incomes that are actually below the poverty threshold -- far too low to be affected by virtually any income tax increase, along with another 2.5 million proprietors filing returns which are nontaxable even under existing tax provisions. The apparent double-counting of taxpayers under the Treasury methodology raises serious questions about Administration arguments in support of its tax increase. However, the most fundamental problem with the Administration's argument is that it ignores the high proportion of small business ownership among those targeted under the Clinton tax increase.

Furthermore, IRS data show that taxpayers subject to the higher top tax rates do indeed respond to changes in the top tax rate. For example, in 1991, after the top tax rate was increased, the income taxes paid by the top 1 percent declined, while revenues derived from all other taxpayers increased.

The 1990 increase in income tax rates enacted by Congress was based on the argument that tax increases on the rich were needed to restore tax fairness. According to supporters of the tax increase, high income taxpayers had received a windfall under the rate reductions of the 1980s, and higher income tax rates would return some measure of "fairness" to the tax code. Using similar logic three years later, President Clinton built upon the 1990 tax increase and based his own tax increase on the notion that tax payments of the rich declined in the 1980s.

In sum, there are many reasons to expect that revenues projected under the Clinton tax bill will not materialize. Higher income taxpayers and small businesses will move to lower their exposure to the higher tax rates, and in the long run a reduction in

economic growth will also reduce baseline revenues. Preliminary Treasury data suggest that revenues are already coming in below projections, despite a pick-up in economic growth.

THE ECONOMIC GROWTH DEFICIT

For more than a decade now, there has been a natural experiment running on how to reduce the budget deficit. The results are in and two conclusions are definitive.

First, historical experience confirms that tax increases fail to reduce budget deficits. Instead, tax increases have the following perverse effects:

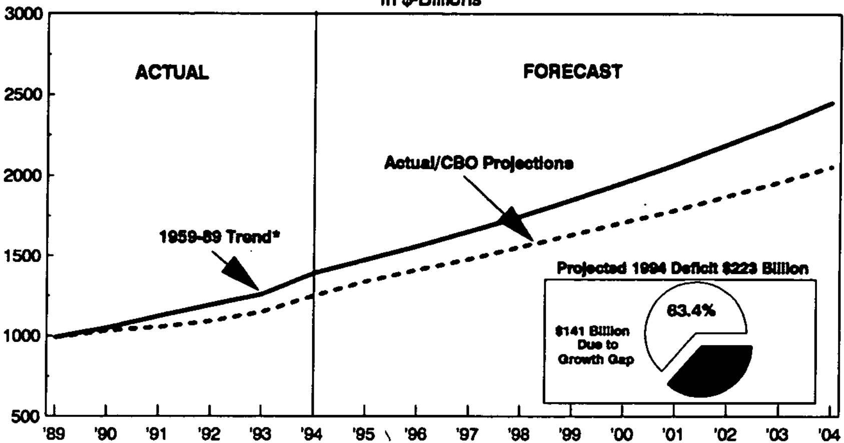
- **Tax increases incite more government spending.**
- **Tax increases alter individuals' behavior inducing them to avoid taxable activities.**
- **Tax increases diminish economic growth and thus reduce revenues.**

In short, tax increases stimulate deficits, they don't reduce them.

Second, spending restraint is necessary but not sufficient to balance the budget. Budget deficits will remain a political problem until economic growth is restored to something approaching the U.S. historic experience of 3.0 percent. Economic growth in the 2.5 percent range not only is insufficient to generate ample economic prosperity for America, but such low growth also generates irresistible political pressure for government to spend money to make up the difference.

In order to balance the budget, Congress must break out of the vicious circle in which mediocre economic performance stimulates voter demand for bigger government to compensate for the effects of slow economic growth; which in turn pushes up budget deficits; which in turn forces Congress to raise taxes; which in turn stunts economic growth and government revenues even further; after which the cycle begins again.

The economic growth gap described in Chapter I has an analogue with respect to government budgets: The Growth Gap Deficit, as Chart II.4 illustrates. The top line in the chart depicts the Federal revenues that would have been generated if the economy had performed on average since 1990 as it performed between 1959 and 1989. The lower line represents actual revenues collected between 1989 and 1993 and CBO projections of revenues under its economic forecast for the years 1994-2004. The area between the lines comprises the Growth Gap Deficit.



*Trend Revenue Growth 1959-89 = 3.0%

This chart illustrates the powerful effect economic growth has on the deficit. For example, $433 billion in cumulative revenue was lost in the five years between 1990 and 1994 as a result of economic growth falling below its historic norm. By the year 1994, $141 billion, or 63.4 percent of the projected Federal budget deficit ($223 billion) can be accounted for by this gap in economic growth.

By the year 2004, under current CBO forecasts, in excess of 100 percent of the budget deficit will be accounted for by the subpar economic growth being projected. In other words, the key to balancing the budget is for Congress to exhibit reasonable spending restraint while finding a way to raise economic growth back up to its historic range.

III

THE WEST AT THE CROSSROADS

The fall of communism in the former Soviet Union and Eastern Europe was an historic watershed event that continues to affect every country on the planet. Demolition of the Berlin wall symbolized not only the destruction of communism but also marked the beginning of a world-wide crisis for the welfare state.

In many respects, Western Europe and Japan are experiencing a slow-motion, and thus far more peaceful, version of what transpired in the communist world. America has not gone as far down the road of welfare statism as most other countries. However, it still suffers from similar, if less advanced, enervating policies, and the Clinton Administration proposes to expand these policies on a scale not seen since the New Deal.

Even in America, government intervention into private institutions has taken a heavy toll by fostering a new culture of dependency, not only dependency of the least fortunate, but also a pervasive middle class dependency. President Clinton's recent statements that he wants to "give Americans health," are indicative of the extent to which the current administration seeks to extend middle class dependency on government.

A quantitative measure of government dependency is given by means tested welfare spending, which has risen from its 1960 level of $28.9 billion (in constant 1990 dollars), or 1.4 percent of GDP, to $211.9 billion, or 3.9 percent of GDP, in 1990.[1] Total social service spending jumped from $143.7 billion, or 6.7 percent of GDP in 1960, to $787 billion, or nearly 14.5 percent of GDP today. Yet the percentage of the population classified as poor, which dropped from 35 percent in 1949 to around 15 percent in 1965 (before the start of Great Society welfare programs), has remained about the same since (see Chart III.1).[2]

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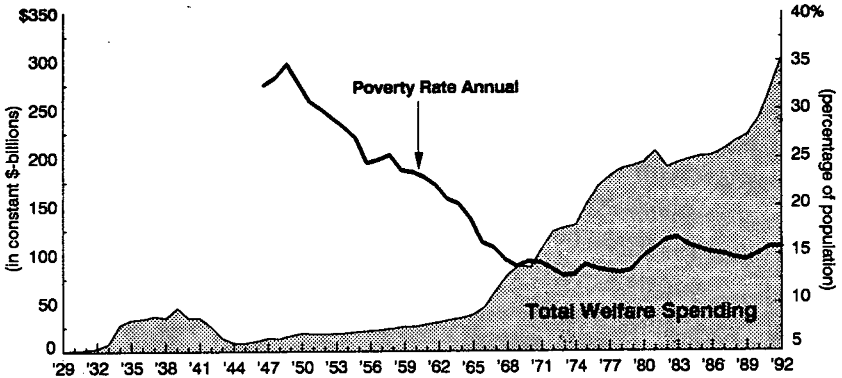
[1] Bennett, William J., *The Index of Leading Cultural Indicators*, Vol I, March 1993, jointly published by Empower America, The Heritage Foundation and the Free Congress Foundation, pg. 21, from U.S. Department of Health and Human Services data.

[2] Rector, Robert, "Despite Welfare Spending Explosion Poverty Rate Remains Unchanged," The Heritage Foundation, September 22, 1993.

Chart III.1 **Welfare Spending Going Up, But Not Reducing Poverty**



Source: The Heritage Foundation.

Advocates of the welfare state claim that crime is caused by poverty and can be cured by more generous government programs. Yet, during the same period of time that government social welfare spending was exploding, so was violence. The number of violent crimes rose from 288,460 in 1960 to 1,820,130 in 1990.

As the former Soviet Union, China and other newly emerging nations join the global economy, the welfare state will come under enormous competitive pressure to reform or collapse. There is a growing recognition of this predicament among Americans. In 1992, they voted for change. Unfortunately, they got more of the same. While employing the rhetoric of reform, most of the Clinton Administration's policies not only persist in the mistakes of the preceding Administration, but also mimic the far more serious mistakes that other Western welfare states are now trying to abandon.

The West faces two distinct possibilities. On the one hand, the disintegration of communism may be only the first stage of a more general process of constructive disintegration of other forms of statism that will sweep the world. The fall of communism may mark the beginning of the decline of big government and the spring of a new freedom from government manipulation and coercion within the western democracies.

Alternatively, the West may cope with the crisis of socialism and the welfare state by going back to the future and embracing another form of statism more reminiscent of precommunist statist regimes -- with the 1990s objective of building information superhighways in the sky replacing the more mundane 1930s goal of autobahns and

making the trains run on time. Instead of shedding the yoke of government control altogether, the West may exchange the welfare state for a new corporatist state in which private institutions persist in name but become ever more entangled with and controlled by governments.

The Clinton Administration's notion of "welfare reform" is a good example of replacing one failed system with another that promises to be an even greater failure. Clinton appears a moderate when he observes that the social welfare system that was meant to protect the poor has failed. He says he rejects the old notion of government handouts. But what he would replace the current system with is a corporatist arrangement in which the government "uses" the market, that is, exploits it with manipulative new taxes, regulations and preferences, in which market participants "cooperate." In other words, government colludes with and cajoles private businesses, through special government aid and threats of tighter government controls, to retrain and employ welfare recipients. All the while, high taxes and regulations mandated by other Administration policies make truly private businesses weaker and less able to absorb more workers. Businesses and workers alike become more dependent on government.

The Clinton Administration's health care reform plan is another example of disguising a massive government takeover of an industry behind the rhetoric and appearance of private markets.

The West truly is at a crossroads, and the Clinton Administration proposes to lead America down the wrong fork in that road.

THE ROAD TO STATISM

In a pure or classical socialist system, the government owns the means of production, including all enterprises, major retail outlets, public utilities and infrastructure. The former Soviet Union and the communist states of Eastern Europe came closest to this form.

A welfare state involves a less severe form of government intervention in the economy. In the narrow American sense "welfare state" denotes a system in which governments redistribute wealth from one group to another, for example, by giving direct handouts of cash or other benefits to the poor. But in the broader sense, "welfare state" can refer to the countries of the democratic West that practice various degrees of government planning and control of economies.

Private individuals still legally own most of the enterprises in a welfare state. But their rights to use their property and to contract freely with other individuals are circumscribed and sometimes severely restricted. In Western Europe and increasingly in the United States, such systems, more properly called "corporatist," involve government direction of business activities, sometimes favoring one enterprise or sector

over another with direct handouts, lines of credit, trade protection or other direct benefits. Especially characteristic of a corporatist system is government control of labor policy, in which governments have substantial direct involvement in controlling private hiring practices, mandating salaries and benefits, and jobs training. Especially in the case of Western Europe, most workers receive generous unemployment benefits.

In this report "welfare state" is used loosely to describe western European democracies and the United States, all of which fall at various points along the continuum from the free market to Socialist systems. While the systems vary in the amount of government control and intervention, they all are distinct from the kind of free market system more closely approximated by the Pacific Rim countries at one end of the spectrum and the socialist systems of direct government ownership of the means of production that so recently have collapsed.

A number of factors have created the crisis of the welfare state:

- Government ownership and heavy-handed control of industries, along with mandated benefits for workers, have held down productivity and job creation;

- Government attempts to pick winners and losers have diverted resources from their best and most efficient use into less-competitive industries and discouraged entrepreneurial efforts in more promising sectors;

- High taxes and high government spending have siphoned resources from the private sector, thus depressing economic growth.

- Social welfare policies have discouraged industriousness and rewarded failure, discouraged personal responsibility and foisted the costs onto productive entrepreneurs and individuals.

- Entangling government with private institutions has led to serious corruption problems and politicized most facets of life resulting in excessive use of punitive measures to control vast areas of private life and domination of public life by special interest groups.[3]

The general growth-dynamic of the welfare state can be summed up as follows: Government intervention and redistribution is justified in the first instance by a special, sometimes horrifying, case of poverty or the misfortunes of particular individuals. Government grows through the accretion of one "special case" after another and requires an increasing share of the private economy. Taxes must go up. In order to maintain

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[3]Delong, James V., "The Criminalization of Just About Everything," *The American Enterprise*, Volume 5, Number 2, March/April, 1994, pp. 26-35.

middle class political support for the regime, politicians are forced to purchase it with expanded middle class government largess, which in turn accelerates the growth of government from an accumulation of "special cases" to the general case. Moreover, as economic performance suffers and social problems mount as the direct result of growing state intervention, the middle class demands further economic intervention and manipulation by government in an ill-fated effort to solve the very problems created by government in the first place.

The welfare state, therefore, is an inherently corrupting institution. It thrives on the dependency of its citizens. Once dependent on it, there is no obvious way for average citizens to disentangle themselves from it. It is corrosive of all private intermediating institutions in society, seeking to harness each of them for its own purposes.

Alexis de Tocqueville put it best 150 years ago in *Democracy in America*:

> [The government] covers the surface of society with a network of small complicated rules, minute and uniform, through which the most original minds and the most energetic characters cannot penetrate, to rise above the crowd. The will of man is not shattered, but softened, bent, and guided; men are seldom forced by it to act, but they are constantly restrained from acting. Such a power does not destroy, but it prevents existence; it does not tyrannize, but it compresses, enervates, extinguishes, and stupefies a people, till each nation is reduced to nothing better than a flock of timid and industrious animals, of which the government is the shepherd.[4]

Government's Growing Grip

By the 1960s, all of the governments of Western Europe, and to a lesser extent Japan and the United States, were embarking on policies of increased state intervention in their economies. The degrees and kinds of interventions varied. The adverse effects in some cases were quick in coming. In Britain, for example, which adopted rather undiluted socialist policies after the War, the "British Disease" developed early. More generally, however, the economic consequences of the welfare state took more time to manifest themselves. There were a number of reasons for this.

First, in the period of rapid economic expansion after World War II, markets were able to absorb and obscure the inefficiencies introduced by governments. For a period of time, the adverse effects appeared minor. Over time, however, the adverse effects accumulated.

Second, in most cases state controls were introduced gradually, over a period of years or decades, with a correspondingly slow manifestation of the adverse economic effects. The cause-and-effect relationship between the growth of government and deleterious economic outcomes was obscured in the minds of many citizens. Typically,

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[4] de Tocqueville, Alexis, *Democracy in America*, Vol.II, Book IV, Chapter 6, pg. 319, July 1990.

by the time the unintended and detrimental consequences of one government action occurred, they had become disassociated from their original cause in the minds of voters.

Liberal politicians also went out of their way to create fictitious linkages between the problems and "market failure." Health care is a prime example (see side bar below).

Instead of growing public pressure for repeal of the government interventions that caused the problems, elected officials were able to placate people by offering new government solutions for the problems created by government in the first place. Problems compounded themselves as government replaced or conscripted private institutions for its own purposes. In time, people grew increasingly unfamiliar with and alienated from the ability of private institutions and private markets to efficiently perform actions now regulated by government.

Good Intentions, Harmful Effects

"Reform? I don't know if I can take any more reform. Things are bad enough as they are."
Lord Maculay

There is a growing national consensus that "there oughta be a law" against health insurance companies being able to exclude "pre-existing conditions" from coverage under health insurance policies. There is a growing misconception that Congress can simply outlaw exclusions for pre-existing conditions with little or no cost to taxpayers and policy holders. To the contrary, this apparently mild-mannered reform would cause enormous harm for very little good. The ban would trigger a chain of events that would cry-out for more government control of the medical marketplace.

Suppose Congress prohibits insurance companies from turning down an applicant based on that person's health status. At that point, everybody knows he or she can buy insurance at any time, sick or well, and pay the same premium as everybody else. Why buy insurance at all? It would be foolish to pay premiums when you don't need medical care. Instead, wait until you get sick and then buy coverage. Insurance premiums would skyrocket under such a system. When people are permitted to insure themselves after the fact, only the sick will purchase "insurance."

In fact, insurance would end in the sense of providing protection against the risk of financial catastrophe. The policies become "prepaid consumption," not insurance. Insurance only makes economic sense when it covers risk. When it becomes prepaid consumption, premiums must be high enough to cover the anticipated costs, and no one thinks it's a good deal. The unintended consequence of a ban on exclusions for existing conditions would be a drastic decline in insurance coverage among Americans, soaring premiums and a crack-up in the market for private health insurance — the very opposite of the intentions of the health reformers.

In 1993, New York state passed legislation requiring insurers to 1) enroll all applicants regardless of health status ("guaranteed issue"), and 2) charge all persons the same premiums ("community rating"). Mutual of Omaha reports that during the first nine months under this reform, 60 percent suffered premium increases and 40 percent benefitted from premium decreases. Rates for single males, age 30, jumped 170 percent. In just eight months, individual policies declined from 50,000 to 35,000, a drop of 30 percent. A random survey of nearly 500 persons who dropped coverage showed that a majority dropped it because of the premium increases, and over four in 10 went without new insurance.

Many policy makers know about this problem, so their next step would be to require everyone to have health insurance. But mandating that everyone buy insurance raises two major questions: 1) Who will pay? 2) How much must they pay? Mr. Clinton prefers employers to pick up most of the tab, while some other proposals prefer individuals to pay. Either way, all the people forced to pay will insist that the government make it affordable by restricting increases in insurance premiums and requiring that the sick pay the same rates as everyone else.

When market forces are ignored, any attempt to do good through one governmental reform leads to a tangled web of additional unanticipated interventions. The market for private health insurance could be killed by a few "small" reforms.

There are solutions, but they are not to be found in command and control regulations that mistake good intentions for sound policy. For example, high-risk pools can cover the 1 percent who are medically uninsurable. Guaranteed renewability of insurance policies would ensure that people do not drift in and out of the market at will. And health insurance made portable by extending the deduction to individuals would allow everyone, including those with pre-existing conditions, to keep their coverage when they change jobs.

Most of the restrictions that have emerged in the marketplace are there for a good reason. Before using government to force change, policy makers must take care to do more good than harm.

A third reason harmful interventions into the economy were able to accumulate unnoticed was that, in some cases state-introduced inefficiencies in one area were offset and masked by concomitant market liberalization in other areas. The best examples are the removal of trade barriers and expanding the size of the European Community (EC), and the global reduction of trade barriers from a series of rounds of the General Agreement on Tariffs and Trade (GATT), which helped expand global commerce.

A recent example of this phenomenon can be found in the gasoline tax hike of 1993. At a JEC hearing in January of this year, the President's supporters argued that last year's gasoline tax increase helped the economy because although the Federal tax was raised by 4.3 cents per gallon of gasoline in October 1993, the average price per gallon went from $1.15 per gallon in September of last year to $1.13 per gallon now, a 1.7 percent decline.[5] What the gas tax advocates fail to point out is that world oil prices have been dropping. The price of Texas crude oil declined by 31 percent, going from $20.30 per barrel a year ago to around $14 per barrel currently. The difference between the amount that prices actually fell and the amount they would have fallen without the tax increase represents what economists call the "opportunity cost."

Opportunity costs are real but governments can obscure their existence. Governments often have a knack for commandeering private resources or imposing new regulations just when the economic times are ripe so that the immediate disadvantages of their actions will be hidden and future adverse effects will not be connected with the cause in the public's mind.

Fourth, while the welfare state was growing, most of the western economies had a larger percentage of their GDP generated through trade. For example, American exports and imports as a percentage of GDP was 8 percent in 1960 and 16 percent in 1990. German trade amounts to nearly 40 percent of GDP and for many of the smaller industrialized countries, the percentage is over half. A growing reliance on international trade meant that countries had to take care to avoid policies that might make them less competitive internationally. It also meant that it was best for each government to increase controls on its economy in synchronization with others, to make certain that it was not too far ahead of its neighbors. Too much government control while other countries remained freer would put a country at a competitive disadvantage. With the

[5] During a JEC hearing with Federal Reserve Board Chairman Alan Greenspan, January 31, 1994.

rise of competitive economies from the ranks of the less developed countries, especially in the 1980s, competition became even more intense and the adverse effects of government-created economic inefficiencies thus were much more keenly felt.

The 1980s

The 1980s saw a slowing and in some cases a reversal of the growth of the state. This was most notable in the United States under President Ronald Reagan, where economic reforms resulted in seven years of economic prosperity.[6] Similar market reforms occurred in Britain under Margaret Thatcher, and other countries, for example, France, began to liberalize their economies as well. Chile set a free market example early in the decade. Other less developed countries, such as Argentina and Mexico, after struggling through economic crises rooted in foreign debt problems, have followed by adopting radical, market-oriented reforms.

Since the end of the Reagan era, the global trend has turned back towards increasing state intervention. The welfare state's policies are like any other dependency. While Reagan and like-minded leaders abroad were able to whittle away at the use of welfare state policies and slow down their growth, the addictive policies that caused the dependency remained firmly in place and tempted a relapse.

Unneeded and wasteful government agencies were not shut down. Social service policies that encouraged unproductive behavior and broken families remained in place. Total social spending grew from $584.8 billion in 1980 to $787 billion in 1990, measured in constant 1990 dollars. Constitutional checks on the Federal government's power were not put in place, and power was not devolved to the states and localities.

Thus, without strong, visionary leaders like Reagan to continue the uphill battle for reform and rehabilitation, interest groups and the liberal politicians who depend on them for political support were able to appeal to people's latent dependency on government by offering government as a "solution" to America's problems. Activist politicians sent up the cry that America's problems were the product of government inactivity which they claimed was caused by "grid-lock" in Washington. The Republican

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[6] Bartley, Robert L., *The Seven Fat Years*, Maxwell McMillian International, 1992.

Party, which had been engaged in the difficult task of breaking dependency found itself labeled the "guardian of grid-lock." Just saying "no" to bad ideas was portrayed as obstructionism and, before long, increased government activism accelerated and soon reversed much of the progress of the 1980s.

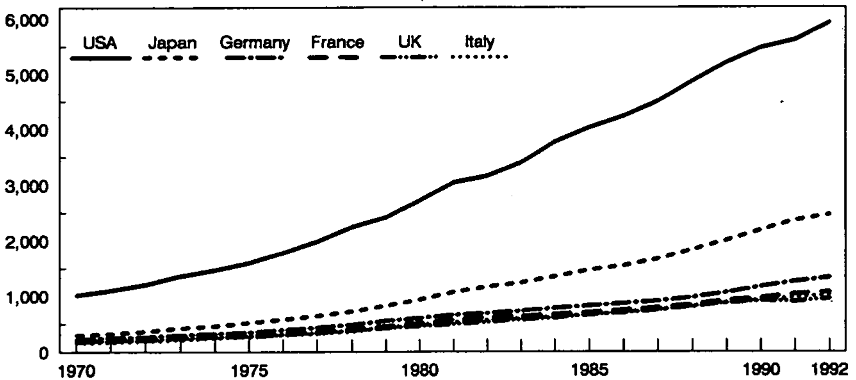
THE CURRENT SITUATION

The United States remains the strongest economic power in the world. Indeed, one measure of the extent of the world-wide crisis of the welfare state is that for all of America's problems, the economic outlook for the United States is more promising than for any other major industrialized country.

Gross Domestic Product

The United States still has the world's largest economy. With an estimated GDP of $5.92 trillion in 1992, using purchasing power parity, the American economy is more than twice Japan's GDP of $2.448 and four-and-one-half times the size of the western Germany's $1.325 trillion GDP (see Chart III.2 below).[7]

Chart III-2 **America Still Leads Gross Domestic Products**



Source: OECD National Accounts.

[7] OECD, *National Accounts*, 1994.

Jobs and Unemployment

Over the past decade more jobs have been created in the United States than in the other major industrial countries combined. Between 1982 and 1989 America added 18 million workers to payrolls, an 18 percent increase. This compares to 5.4 million or 10 percent job growth for Japan during that period and 1.1 million or 4.2 percent growth for West Germany.

Unemployment in Western Europe now averages around 12 percent, nearly twice as high as in the March 1994 rate of 6.5 percent in the United States. By contrast, the rate for western Germany rose from 6.3 percent in 1991 to 9.1 percent in January. Unified Germany's unemployment rate is around 12 percent, with a postwar record 4.03 million out of work.

Sweden, once considered the socialist country that could guarantee full employment, saw unemployment jump from 1.6 percent in 1990 to 9.2 percent in the third quarter of last year. Swedish employment figures have always been deceptive. The Swedish government regularly places the unemployed in government-sponsored public works or job training programs and lists these individuals as "employed." But now, even by their own measure, Swedish statistics demonstrate the failure of government-created full employment. Making matters worse, the number of government jobs in Sweden grew from 21 percent of all jobs in 1970 to 33 percent in 1991.[8]

In addition to high unemployment levels, extremely generous unemployment compensation benefits produce unemployment trends in Europe that are longer term than in the United States. In 1989, 90 percent of unemployed Americans were out of work for less than six months. Only 6 percent were out of work for more than a year, compared to 44 percent of Frenchmen and 49 percent of Germans.[9]

Unemployment in Japan has increased from around 2.2 percent in 1990 to 2.9 percent in December 1993. While this is low compared to the United States, it still is high by Japanese standards. The wages of many Japanese workers, unlike those of most Americans, are very flexible. As much as a third of the average worker's income is paid in the form of bonuses based on how well a company performs in any given year. This means that for short-term economic slowdowns, Japanese firms in effect cut workers' pay and thus avoid the need to lay off workers. Yet the "employment for life" policies of most large Japanese firms are being reevaluated in the face of current economic problems.

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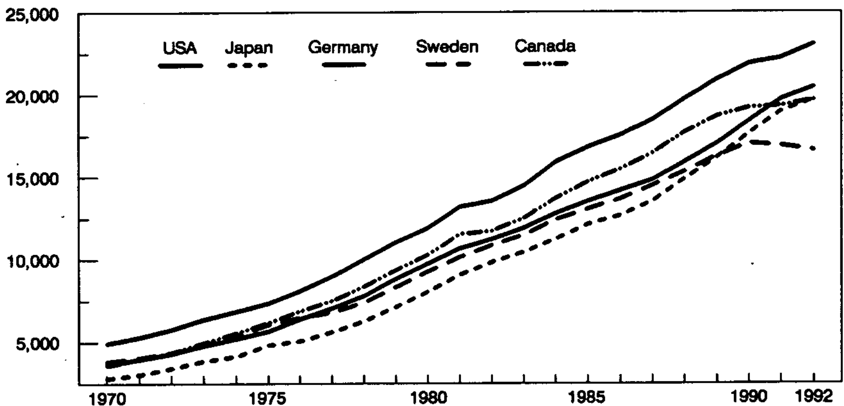
[8] Samuelson, Robert, "The Swedish Disease," *The Washington Post*, December 8, 1993, pg. A23.

[9] McKinsey Global Institute, "Service Sector Productivity," October 1992.

Living Standards

After World War II, the living standards in all industrialized, democratic countries rose. It could be expected that since the major Western countries had similar levels of development, education, and access to resources before the War, that their living standards would grow close to each other. While all are certainly in the same class when compared to, say, the less developed countries of African, Latin America and parts of Asia; the United States still has living standards notably higher than the others.

One way to measure living standards is to calculate the average income of each country in terms of "purchasing power parity," which adjusts for distortions introduced by exchange rate fluctuations. Using this measure, in 1992 the United States had a per capita income of $23,215, compared to $20,435 for western Germany, $19,689 for Japan and $16,590 for Sweden (see Chart III.3 below).[10] Of these four countries, only the American economy has grown over the past two years, which means the gaps between the United States and the others are expected to widen when new figures are available.



Source: OECD, International Labor Organization, 1992 figures, March 1994.

[10] OECD, International Labor Organization, Purchasing Power Parity 1992 figures, published March 1994.

Other indicators also show American living standards to be higher. For example, the average Japanese consumer spends nearly 25 percent of his income on food, compared to 12 to 15 percent for the average American. The Japanese spend nearly twice as much for housing, and have less living space per person. Two joint U.S-Japanese government studies respectively showed that consumer prices in Japan are on average 41 percent higher than in the United States, in October 1989, and 37 percent higher, for April 1991.[11] Nearly half of the dwellings in Japan do not have indoor toilets.

These lower living standards are due in part to the gross inefficiencies of the distribution system in Japan. Further, the non-tariff trade barriers that have made it more difficult for American firms to market their goods and services in Japan also have raised prices for Japanese consumers. Rice, for example, costs 400-500 percent more than the world market price.

Productivity

America's high living standards should come as no surprise. It is still the world's most efficient producer of goods and services. The output per full-time worker in the United States for 1990 was $49,600 annually, compared to an output of $44,200 for each German and $38,200 for each Japanese. On average, the average hourly output per all workers in Germany and Japan is only 80 percent that of American workers.[12]

While America has not surrendered its lead in productivity in the postwar era, in the 1980s other industrialized countries had more rapid rates of productivity growth. Using 1985 seasonally adjusted as a base year equal to 100, Japan hit a level of 127.7 in 1991. But by October 1993 it sunk to 110.9, and only recovered to 113.1 in November, compared to a 108.3 level for Germany and a 119.8 rate for the United States.[13]

Other Indicators

Other economic factors suggest the depth of the problems now experienced by the industrialized countries of the West. Stock market rises as such are not necessarily an indication that an economy is doing well. During the 1991 recession in the United States, the New York Stock Exchange continued to climb for example. However, a precipitous and sustained drop in a stock market can indicate that the businesses and assets in an economy have been overvalued and that the economy has less strength than

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[11] Yager, Loren, *Price Comparisons Between the Japanese and the U.S. Markets*. RAND Corporation Center for U.S.-Japanese Relations.

[12] McKinsey Global Institute, *op. cit.*

[13] OECD, *Main Economic Indicators*, January 1994, pg. 15.

investors originally thought. Since 1991 the Japanese stock market has dropped by 40 percent. The 1991 high of 27,146.9 fell to a low of 16,087.7 in 1993.

Land values also give some indication of a country's economic condition. And in both Sweden and Japan, land values have been cut in half over the past two years.

CAUSES OF THE CRISIS

Size of the Public Sector

America still has a smaller public sector than most other industrialized countries although if President Clinton has his way, the United States will catch up fast. In 1992, total direct government outlays in the United States was 35.4 percent of GDP, compared to a 41.2 percent average for all OECD countries, a 49.4 percent rate for Germany and an average 51 percent rate for all Western European countries.[14] Japan, with government outlays of only 32.2 percent of GDP is the only major country with a lower rate than the United States

These figures understate the actual amount of state control of economies. For example, the best estimates of the annual Federal regulatory burden on American businesses and individuals is over $500 billion.[15] The burden in other industrialized countries no doubt is of a similar magnitude, if not worse.

The Clinton Administration seeks to enlarge the state sector in America to European proportions. For example, the Clinton health care reform plan alone would bring an additional 14 percent of the American economy under Federal government control.

Taxes and Spending

The most obvious way that democratic governments influence economies is through high rates of taxes and spending. In the United States, there has been a growth of taxes and spending over the past two decades. The share of GDP spent by the U.S. government has grown from 17.9 percent in 1960 to around 23 percent today. When state and local government spending is added, the total is around 35 percent. For Sweden, in 1993, the government outlays equaled 73.5 percent of GDP.[16]

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[14] OECD, *Economic Outlook*, 53, June 1993, p. 215.

[15] See Thomas D. Hopkins, "Costs of Regulation: Filling the Gaps," Regulatory Information Service Center, Washington, D.C., August 1992, and various updates.

[16] McCracken, Paul, "Unemployment–the Crisis Continues," *The Wall Street Journal*, January 7, 1994.

Once the mandated premiums for Clinton's proposed health care plan and the related spending are brought onto the Federal budget, as CBO says they should be, Federal spending as share of GDP would equal a minimum of 37 percent; and total government spending at all three levels would comprise 49 percent, almost the OECD average.

While America's budget deficit as a percentage of GDP was about 4 percent of GDP last year, Sweden went from a 1990 surplus of 1 percent of GDP to a 14 percent deficit last year.

The Clinton Administration last year took another step in the direction of the European approach to fiscal policy by pushing through Congress a $275 billion tax increase. This tax hike was the largest in American history and dramatically raised the tax on saving and investment by raising marginal tax rates.

While Clinton proposes to cut defense spending from $292.4 billion in fiscal 1993 to $258.2 billion in fiscal 1999, total Federal expenditures during that period will grow from $1.408 trillion to $1.83 trillion, a $422 billion increase.

The Welfare State: Europe vs. America

The regulation of European economies by their governments is the principal cause of Europe's current economic problems. There are some important distinctions between these policies as practiced in Europe and America. Direct government-to-person welfare in Europe by some measures might not be higher than in the United States. This is because Europe governments directly regulate their workplaces more than the U.S. government manages America's workplaces. In America, the government allows the market to operate more freely and then redistributes income through taxes to provide benefits. This approach to redistribution somewhat mitigates the extent to which business productivity is hindered. European governments interfere more at the level of production, which means mistakes can have a more direct effect on production.

Labor Market Inflexibility

German labor policy makes it difficult for employers to use workers in the most economically efficient manner. The German government sets many standards for working hours, leave and so-forth. Further, unlike in the United States, the German government mandates that most enterprises allow employees to participate in management through "works councils." Further, about 40 percent of German workers are union members, compared to only 18 percent.[17] And the wages of some 90 percent of

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[17] Palmer, Edith, "Germany" section in *Labor Laws In Select Foreign Countries*, Kersi B. Shroff, coordinator, Law Library of Congress, January 1991.

German workers are determined by collective bargaining agreements, most influenced directly or indirectly by the government.

German law mandates notice periods for dismissal of employees which grow in length with seniority. Until 1990, white collar workers had preferentially long notice periods. This notice requirement not only makes it difficult for German firms to dismiss unsatisfactory workers, but guarantees that the longer a worker remains with a firm, the more difficult it will be to get rid of him. The German government mandates that only "socially justified" reasons can be used to dismiss a worker. Further, employers must consult with works councils before a dismissal. If a worker feels he is unfairly dismissed, he can appeal to the Courts. In the case of layoffs of a substantial portion of a company's work force, employers also must consult with works councils.

Currently, the U.S. Congress is considering legislation proposed by Senator Edward Kennedy (D.MA) and Representative William Ford (D.MI) to require similar worker's councils in the American workplace, though initially with less power than the ones in Germany have secured for themselves.

One piece of legislation pushed by the Clinton Administration that would make America's labor market less flexible would make it illegal for an employer to hire permanent replacements for workers on strike. Such a policy would remove much of the risk that workers face when they go out on strike and thus strengthen the power of big labor unions. Employers often would have little option but to hire back strikers.

The Costs of Labor

The costs of labor in other major industrial countries are higher than in the United States. For example, workers in western Germany receive 40 mostly government mandated paid vacation or holidays annually, Swedes receive 37 days and French workers receive 35 days, compared to 23 days for Americans and 26 for Japanese.[18] Each day, 12.2 percent of the workforce in Sweden is absent, 9 percent of West Germans are out each day and 8.2 percent of Frenchmen, compared to 3 percent of Americans and 1.7 percent of Japanese.

The total costs of providing wages and benefits are $26.90 per hour for each German worker, $24.65 for Swedes and $19.23 for Japanese compared to $15.89 per hour for American labor.[19] It is therefore not surprising that Germany's Mercedes-Benz was laying off 8,000 workers in 1993 and planning 14,000 layoffs in 1994, while

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[18] Cohen, Roger, "Europe's Recession Prompts New Look at Welfare Costs," *The New York Times*, August 9, 1993, pp. A1 & A8.

[19] *Ibid.* Figures from a Morgan Stanley Survey are slightly higher for all countries. See cite in David Wessel, "The U.S. Economy May Dominate for Years," *The Wall Street Journal*, January 10, 1994.

planning to build a auto plant in Alabama.[20] The Clinton health care plan would move the United States closer to the European average and permanently raise the cost of labor.

These high benefit levels have the seemingly paradoxical effect of holding down real living standards for European workers. This is because in most cases, nominal wages rise but actual output per worker does not. A worker's real pur-chasing power can rise with an increase in the production of goods and services. When governments simply mandate that employers pay workers more benefits, no new wealth is created. Such redistribution in the short term can benefit one group of workers at the expense of others. In the long term, if productivity suffers, there simply will not be as many goods and services to consume. Furthermore, liberal leave policies are subject to abuse which produces high levels of absenteeism.

The Clinton Administration proposes to add substantially to the cost of hiring workers by mandating that all employers provide health care coverage for workers.

Further, the Administration has indicated that it will push for an increase in the current $4.25 per hour minimum wage when the time is right politically. Proponents of a higher wage maintain that it is impossible to live or raise a family with the current wage. But less than 10 percent of those who receive a minimum wage are single earner heads of households, and these can obtain various forms of direct supplemental income assistance from the government.

Most of those earning a minimum wage are teenagers or other part-timer workers. Raising the wage to, say, $4.75 per hour, it is estimated will eliminate or prevent the creation of between 75,000 and 100,000 jobs. This would especially harm entry level workers, for example, in fast food restaurants and retail outlets, who not only receive income from their jobs but also learn basic work habits such as showing up on time, disciplining themselves to the needs of the job and attending to customer needs. Ironically, the Clinton Administration has sought funds for government summer jobs for teenagers. Taken with the job-destroying effects of a higher minimum wage, this policy would have the effect of weakening the private sector and replacing its function with a public sector program, part of the pattern seen in Europe over past decades.

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[20] "Getting Europe Back to Work," *The Economist*, August 28, 1993, pg. 43.

Unemployment Compensation[21]

Unemployment benefits in Europe tend to be much more generous than in the United States, Germany and France (as well as Canada) spent on average more than 1 percent of GDP annually on various forms of unemployment compensation during the 1980s, compared to about .6 percent for the United States. Further, the portion of GDP spent per percentage point of unemployment is slightly over .2 percent in Germany in 1990 compared to slightly over .1 percent in the United States

Unemployed Americans during the 1980s received around 50 percent of their previous pay for a maximum six months. Germans could receive 58 percent for their pay, and while some benefits run out after one year, others can continue indefinitely. The Dutch receive 70 percent of previous pay for three years.

European countries in general are much more generous in giving benefits for workers who leave a job voluntarily or who are fired for misconduct. In the United Kingdom such workers are disqualified from benefits for only six weeks, for Germans, up to 12 weeks, but 26 weeks for Americans.

Other labor policies contribute to Europe's current poor economic showing. An estimated 18 percent of the workers in the Netherlands receive some form of disability benefit from the government. For example, a 48-year-old assistant professor with a position at Delft University has stopped working for the past three years and collects $1,630 per month in disability benefits, claiming his work is too stressful.[22]

In Sweden, the state basically takes charge of the area of employment. The Social Democrat Party, which established the welfare state in the 1930s and ran it until recently being voted out of office, worked closely with the labor unions and the National Labor Market Board to manage the labor market. Local government offices ran job placement, training and public works services. Unemployment problems generally were handled through this system. The result, as noted earlier, is that Swedish productivity and real economic growth has been among the slowest in Europe and unemployment has skyrocketed to over 9 percent.

Changes in welfare policies proposed by the Clinton Administration appear to be modeled on the failed Swedish model. He wishes close, corporatist "cooperation and coordination" between employers, Federal government planners and unions. He says that he wants a two-year limit for persons on welfare. But after that two years he would have the Federal government guarantee jobs in the public sector if needed.

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[21] Most material in this section from James R. Storey and Jennifer A. Neisner, Unemployment Compensation in the Group of Seven Nations: An International Comparison, Congressional Research Service, The Library of Congress, April 23, 1992.

[22] Cohen, *op. cit.*

The High Cost of Subsidies

Throughout the postwar era, European governments have intervened to help particular industries, through direct handouts of subsidies and favors, or through indirect forms of assistance. The result has been to divert resources from more promising productive investments to money losing, less valuable ones.

- The European Union (EU), formerly the European Community, for example, provides around $30 billion each year in price supports, export subsidies and other forms of assistance to its farmers. Further, the EU maintains trade barriers to imports of many agricultural products. Japan in general has a market more open to food imports, and is America's largest customer for agricultural goods. But Japan also has, until recently, banned foreign rice from its market. The United States also pays tens of billions of dollars in subsidies to its farmers each year and maintains trade barriers to farm imports.

- European governments have provided billions of dollars to subsidize steel production and shipbuilding. These industries have lost money. Further, the growth of output of these products by such emerging industrial countries as Brazil, South Korea and Taiwan have created a world glut.

- In the 1960s, the British and French governments spent hundreds of millions of dollars to develop a Supersonic Transport plane and today, spends millions to subsidize its operation. In the 1960s, the U.S. government spent $920 million on this project before abandoning it in 1973 as a waste of money.[23]

- **MITI: Myth and reality.** Some Americans maintain that Japan's Ministry of International Trade and Industry (MITI) is responsible for the successes of Japanese industries. This is not accurate. First, most of MITI's funds have gone to support inefficient, non-export industries, for example, energy production and shipbuilding, until it became too costly and wasteful. Second, industries have often prospered by ignoring MITI's advise. For example, MITI advised Japanese firms in the early 1950s not to go into the electronics field. And in the late 1950s MITI advised Japanese auto makers to reduce the number of models they produced, advice that was ignored to the great profit of Japanese auto industry. MITI's build-up of the country's steel industry in the 1960s and 1970s

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[23] Edelman, Susan A., "The American Supersonic Transport," in Linda R. Cohen and Roger G. Noll, *The Technology Pork Barrel*, (Washington: The Brookings Institute, 1991).

only wasted resources and resulted in lay-offs of 50,000 workers over a five-year period in the 1980s.[24]

- While the U.S. government has protected many industries, such as steel and textiles, with trade protection, it has not generally passed out massive subsidizes to particular industries. This has meant that American producers and investors wasted less money than their European counterparts on otherwise less profitable ventures and, thus, put more resources into new, cutting-edge industries. This choice in part explains why most personal computers and the software that makes them run are made in the USA, and not, for instance, in Germany.

The Clinton Administration strongly favors national industrial planning by political appointees and special interest groups. For example, the Administration has championed the so-called National Competitiveness Act which would appropriate funds for government to use to form investment partnerships with private sector firms. This is the same approach that Germany and other European governments have used to direct industry.

Market Successes or Industrial Policy Failures?

Some American policy makers point to the past successes of some industries in Western Europe and Japan to government planning and direct assistance, and advocate similar policies for the United States. But upon inspection, this policy is seen as a major cause of the current problems in these countries. In many cases the successes either occurred in spite of rather than because of government aid, or at such a high cost and sacrifice of other industries that the success in terms of the entire economy is illusory.

- High Definition Television (HDTV).[25] This is one of the clearest examples of the fallacy of governments attempting to pick economic winners and showering their choices with state largess. Japanese businesses, with subsidizes that totaled $1 billion from their government, in the late 1980s sought to develop a high definition television, using existing analoge technology. Thomson Consumer Electronics of France, a subsidiary of that country's state-owned Thomson S.A., received around $1 billion to develop a similar system.[26] American firms sought, but were denied by the Bush Administration, about $1.2 billion in subsidies to compete with these foreign rivals. The U.S. government in the end

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[24] Zinsmeister, Karl, "MITI Mouse," in *Policy Review*, Spring, 1993.

[25] See chronology in Cynthia A. Beltz, "Lessons from the Cutting Edge: The HDTV Experience," *Regulation*, Vol. 16, No. 4, The Cato Institute, 1994.

[26] Klebnikov, Paul, "Les folies HDTV," *Forbes*, July 19, 1993.

probably spent around $200 million for miscellaneous research and feasibility studies. As a result American companies were forced to seek an even better, more efficient form of HDTV. They did just that.

- Zenith and American Telephone and Telegraph invented a fully digital system that made the systems invented by the Japanese and Europeans obsolete before they even went into production. Japan has now announced that it will abandon its system, losing about $1 billion in government funds and private investment, and adopt the American system. The French firm also lost $1.3 billion. If the Bush Administration had listened to those who advocated subsidies to compete with Japan, all countries would be working with inferior technologies and, rather than being the best in the field, America firms would be a few among the mediocre.

Free Trade versus Economic Management

Trade liberalization in the postwar era, especially through a series of negotiating rounds under the GATT, has helped promote both peace and prosperity worldwide. The creation in 1957 and subsequent expansion of the European Community did the same for Western Europe.

But in 1985 the EC members recognized that the United States and Japan were far more economically competitive than they were. Some even acknowledged that less government economic control in these countries was the major cause of this competitive advantage. Thus the EC members decided to move quickly to remove the remaining trade barriers between their economies, to create a true common market. This EC-1992 project gave the Community an economic kick during the late 1980s. But in 1992 the EC initiated the Maastricht agreement, a plan that many fear will be more managed trade than free trade. The concern is that bureaucrats in the EU administration in Brussels will intrude even more in the already overregulated economies. Of special concern is the so-called "Social Charter," which is a policy that would allow Brussels to attempt to equalize wages, benefits and other factors in the different countries that normally should be determined by the market.

The Clinton Administration was correct to support the North America Free Trade Agreement (NAFTA) between the United States, Canada and Mexico. But the addition of the side agreements, which set up bureaucracies to monitor the so-called "fairness" of domestic policies of the member countries, marred the achievement.

Now, in the name of opening Japan's markets to more American exports, the Administration is not depending on free trade but on trade managed by bureaucrats in both countries. Specifically, it wants to force Japan to guarantee a certain percentage share of its market for particular American products. Additionally, the Administration wants to require Japan to meet macro-economic targets, for example, to reduce its trade deficit to certain levels by certain times.

Those who favor this approach sometimes assume that the Japanese government would be forced to remove trade barriers and restructure its economy if it had to meet targets. But managing trade-by-the-numbers is an economically flawed strategy, in some ways worse than the older forms of trade protectionism.

The more America foists "managed trade" on Japan, the more economic and political power MITI will gain. To make certain that Japanese firms purchase certain quantities of goods from overseas or restrict certain exports, Japan requires a large, strong and intrusive bureaucracy. Mixing politics with economics through MITI is just what American firms complain holds down their sales in Japan. MITI will have the power and incentive to show favoritism to certain foreign and domestic firms. It will be a small step thereafter for pressure to develop within the United States to create a "countervailing" industrial policy bureaucracy.

Political Corruption

Corruption, a problem thought by some to be confined, in its most serious forms, to less developed countries, develops into one of the most serious problems in the industrialized welfare state. Yet few people recognize the magnitude of the problem much less its causes or solutions. To understand the current situation in the West, it is necessary to distinguish two forms of corruption:

Classical Corruption. This kind of corruption occurs when an elected official or government bureaucrat wields political power for personal gain contrary to the explicit letter of the law. Diverting government funds or private funds guaranteed by government programs into private bank accounts for a politician's personal gain is an obvious example. A corrupt official might expedite a license for one businessman while making others wait, or he might grant lenient regulatory treatment to one favored business or industry while penalizing another with harsher tax and regulatory treatment. Or, a corrupt official might offer an undeserved government contract or overlook some legal indiscretion. In exchange, the state official might receive cash, a sweetheart business deal, a paid vacation or some other gratuity.

Institutional Corruption. More destructive of civil society is the form of corruption inherent in the welfare state. By its nature a welfare state breaks down the separation between government and the private sector and thus, between political and economic power. Government is expected to act directly to help this industry or that sector. The public good becomes, in fact, simply interest-group driven policy. This means that policies are often arbitrary and frequently contradictory. In essence, the rule of law gradually gives way to the rule of particular powerful men and interest groups.

Welfare states remain formally democratic but in operation grow oligarchical or even feudal, without real constitutional checks on government power. Ruling parties become entrenched in power. Entrenched parties might make superficial reforms in response to public outrage at abuses of power, but they never limit their own ability to

retain power. And, much of the buying and selling of favors is done, at least technically, in accordance with the law. Corruption is institutionalized and legal.

The U.S. government's structure makes the role of its opposition party unique in the West. Unlike parliamentary systems, Americans can protect themselves against total domination by one party, even if that party dominates the legislative branch, by electing a chief executive of the opposite party. The entrenched ruling party prefers to depict divided government as unworkable. Thus, Democrats characterize Republicans as "guardians of gridlock." In fact, a strong and resistant Republican Party has been largely responsible for preventing a further slide into welfare statism during the 59 out of 63 years the Democrats have controlled the U.S. House of Representatives and the 51 out of 61 years during which the Democrats have controlled the U.S. Senate.

Voters are caught in a dilemma of institutional corruption as well that explains why it is so difficult for them to disentangle themselves once caught in the welfare state's web. Citizens often see the problems caused by the government regulation of the economy. But they, too, have become dependent on the system. Over the decades, entrenched political elites have added one middle-class entitlement to another. Citizens pay large shares of their income in taxes and come to demand commensurate state-produced goods and services and "economic protection" in return.

Given the nature of the system, it does little good for the country as a whole if one group gives up their entitlements. The party in power would simply redistribute any saving to other special interests supporters. Moreover, since governments foreclose many market and private sector opportunities, and because of high levels of taxes and regulations, any group that surrenders an entitlement unilaterally could find itself out in the political and economic cold.

Change in the system in the United States could be as difficult as change in Europe, and for similar reasons. The term "Eurosclerosis" usually refers to the sluggish economic conditions in those welfare states that give rise to calls by the citizens of those countries for help from the same governments and interventionist policies that caused the problems to begin with. The political parties that have purchased favor with various interest groups in the past find it necessary to continue to deliver the goods in the short term, which usually means neglecting long-term reforms. A similar situation exists in the United States, and while the debilitating economic policies have not yet progressed as far here, the growth gap phenomenon discussed in Chapters I and II are manifestations of America's own "Demosclerosis."[27]

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[27] For a popular account of this phenomenon, see the forthcoming book by Jonathan Rauch entitled *Demosclerosis: The Silent Killer of American Government*. A more rigorous analysis that views economic and political sclerosis as an indigenous disease of democracy is Mancur Olsen's *The Decline of Nations*, Yale University Press, NH, 1982.

The disintegration of one welfare state and the hope of a restoration of the rule of law and free markets can be seen in Italy. Last year, disgust over corruption, the ravages of organized crime and the economic problems faced by all European countries incited that country's voters and Senate to revamp its election laws. In the March 1994 election, voters rejected the Christian Democrat Party that had dominated the country's politics in the postwar era. The election's big winner, Silvio Berlusconi and his Forza Italia movement, promised Reaganesque tax cuts, deregulation, privatization and limited government.[28]

THE LESSONS OF HISTORY: THE KEYS TO PROSPERITY

> Contemporary events differ from history in that we do not know the results they will produce... It leads us into an unknown land, and but rarely can we get a glimpse of what lies ahead. It would be different if it were given to us to live a second time through the same events with all the knowledge of what we have seen before.
>
> Friedrich A. Hayek *The Road to Serfdom*

The late Nobel Prize-winning economist and social thinker F.A. Hayek wrote these words from Britain in 1944. He was reflecting on having watched the rise of National Socialism in Germany and now, having fled to England, on watching Britain prepare to set out on a perhaps more gentle but still destructive road to socialism.

Today the failures of the Western European versions of socialism and welfare statism are apparent to citizens and policy makers of those countries who now grope for ways to extract themselves from their systems. This is made more difficult by the fact that these countries have gone so far along the path of socialism that it will be difficult to change the system without causing serious hardships.

In addition, there is a tension between reformers and those who resist reform because they benefit from the system. Reformers, for example, seek economic liberalization in their own countries and hope that the European Union will, for the most part, establish complete free trade within the Union and reduce regulatory burdens. Those who do not wish to abandon the system acknowledge current economic problems. But they are pushing in the opposite direction from reformers. They wish to replace national welfare states controlled by local political elites with an even more intrusive Union-wide welfare state with power centered in Brussels.

And many citizens and policy makers in the Union are simply confused. They know their systems need changing. But they have become so far removed from free markets that they have lost an appreciation of how markets can be the solution to many of the problems that beset them.

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[28] See Edward Hudgins, "A Vote for the Free Market in Italy," *The Washington Times*, March 31, 1994, pg. A19.

This perplexed citizenry is susceptible to the claims of the defenders of the welfare state who often use the language of reform. In many cases the true reformers have not explained the nature of the crisis and effectively articulated the need for fundamental reform, as opposed to tinkering with a system broken beyond repair.

A similar situation with respect to reform exists in the United States. The Clinton Administration and its allies use the language of reformers and stress the role of free markets and private institutions. But upon inspection, most of the Administration's proposals -- from welfare or health care reform to establishing new international bureaucracies to manage "free" trade -- would replace one failed government policy with another even worse policy.

In most respects the welfare state has not advanced as far in the United States, and America's economy is relatively strong compared to other Western countries. America may have the luxury of avoiding the hardships that are now suffered on the other side of the Atlantic and, to a certain extent, the Pacific. A goal for policy makers in Washington, therefore, should be to avoid the fate of a declining welfare state, to use the time and America's remaining economic, institutional and cultural strength to fundamentally change directions before a full-fledged crisis emerges on the European scale.

Fundamental institutional reform. President Clinton has attempted to capitalize on Americans' felt need for change by characterizing himself as a New Democrat. Unfortunately, many of the President's ideas are not new at all. They more closely resemble policies of European socialists than traditional "old" Democrats in America. Instead of devising strategies to move America away from the clearly failed policies that produced Eurosclerosis, the Clinton Administration is explicitly using the European experience as a model for its policies in everything from health care to competitiveness. If Congress goes along with this vision, Demosclerosis in America will spread.

Reinventing Government and Restoring Markets: A Few Modest First Steps

Reinventing Government

The Clinton Administration itself acknowledges that government often operates in a very inefficient manner, is overstaffed, and does not provide the best service to citizens. The President proposed to "reinvent government." To this end he had Vice President Gore undertake a National Performance Review. The resulting study contained many sound recommendations on how to eliminate waste and excess government paperwork and red tape. Republicans support the best of these ideas. Unfortunately, the report failed to

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address the most fundamental issue for any reform: What areas can best be handled by the private sector and should be abandoned by government?

Government, by its very nature, is not subject to the market forces that have given Americans the world's highest material living standards. If a business fails to satisfy the needs to customers, competitors are allowed to offer better service and customers are free to take their dollars elsewhere. Not so with government services. For the most part, those who do not like the way the government is doing things have no alternative. If bureaucrats are piling costly regulations onto business that return little social benefit relative to the cost, or if the bureaucrats ignore less costly, superior alternatives, businessmen and businesswomen cannot ignore government rules. That would invite fines, or jail. When schools fail to provide adequate service, parents can pay out of their own pockets for private schools but they cannot take their tax dollars away from the inadequate school and give them to a superior competitor.

The Clinton Administration talks of providing bureaucrats with some additional flexibility to handle the internal affairs of agencies. While these suggestions have a great deal of merit, they can only go so far in dealing with inefficiencies. Moreover, these reforms and reorganizations do not address the fundamental dilemma inherent in all government bureaucracies.

The great twentieth century economist Ludwig von Mises showed in his 1944 book *Bureaucracy* that the more flexible a government becomes, the more arbitrary its actions will be. The more citizens attempt to restrain the arbitrary powers of governments, through rules, procedures, appeals processes and detailed definitions of due process, the more inefficient they become. Thus, while it is appropriate to make necessary government work as efficiently is possible, citizens face an inexorable tradeoff between efficiency on the one hand and arbitrariness and corruption on the other.

Therefore, "reinventing government" must mean more than "reinventing bureaucracy" to make it more cost effective. Reinventing government must mean rethinking the proper limits of government and restoring trust and confidence in private institutions.

Economic Flexibility

A country's prosperity and living standards rise only with increases in productivity. Productivity is a measure of a country's output of goods and services relative to inputs of the factors of production -- labor and capital. Only with growing productivity can a country become more prosperous. Increased productivity is best ensured when policy makers allow entrepreneurs the maximum freedom to reallocate the factors of production quickly from the production of less highly valued goods to more higher valued uses.

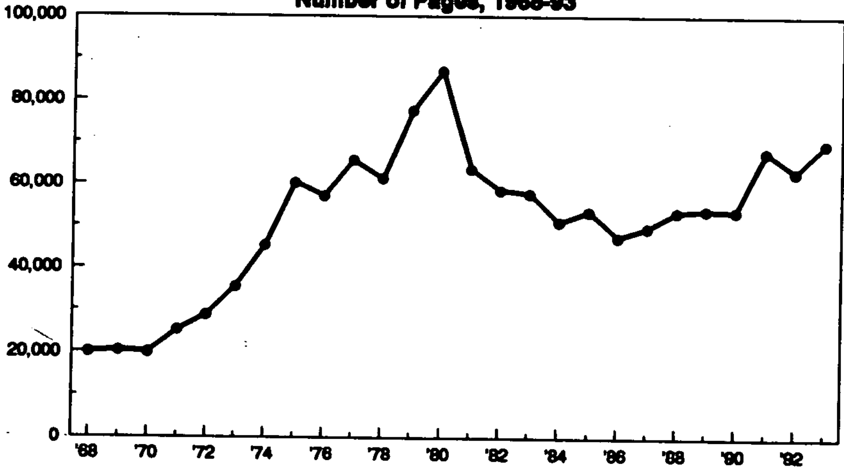
It is also crucial to note that it is never certain before the fact what the best economical use of resources might be and which individuals or enterprises will be the most efficient producers. A central virtue of a free market, with minimal government interference, is that it allows entrepreneurs to experiment, to test their abilities to produce goods and services that they believe will best serve consumer demand.

When governments attempt to aid certain industries and enterprises and hinder others, they, in effect, pollute the experiment.

America's Regulatory Burden

A principal way by which the Federal government controls the economy is through regulations. The burden of Federal regulations on the American economy is massive and growing heavier. During the early and mid-1980s that burden eased, contributing to that decade's economic expansion. The number of pages of the Federal Register, which had reached 87,012 by 1980 dropped to 53,376 in 1988 (see Chart III.4). But since that year, the number again has climbed, reaching its 1993 level of 69,684. The number of Federal regulatory employees, which dropped from 121,706 in 1980 to 104,360 in 1988, now stands at an all-time high of 124,000.

Chart III.4



The actual costs of regulations to the economy will not be found in the national accounts. The Federal government keeps no such records. But independent scholars find the burden currently to be around $580 billion.[29]

Fifteen years ago, Senator Lloyd Bentsen, who is now Treasury Secretary, focused attention on the regulatory burden when he was the Chairman of the Joint Economic Committee. The Committee's 1979 *Annual Report* was the first bipartisan report in the Committee's history. That report observed that "the recent proliferation of regulations and lack of coordination among regulatory agencies have often resulted in regulations which are duplicative, conflicting, and excessive."[30] It noted that the sheer cost imposed on the economy by regulations had grown and yet did not appear in Federal accounts. This statement is more compelling today than when it was written one and one-half decades ago.

Regulatory Budgeting: To keep track of the regulatory burden, Bentsen and the JEC recommended the use of a regulatory budget. Such a budget allows policy makers to judge whether too much regulation is being imposed and to understand the urgency at any given time of identifying ways to protect the public health and safety in a less costly manner.

A regulatory budget treats government mandated costs on the private sector, states or local governments in the same way that any other taxing and spending is treated. Each year, the President would submit a regulatory budget along with the regular budget. The regulatory budget would propose an overall level of costs to be imposed on individuals and businesses, and what level of burdens each government department and agency should be authorized to impose. Congress would debate and vote on both the overall level of regulatory spending and the amounts for each department and agency.

Private Property Compensation: Another way that policy makers can help restore private sector institutions is to ensure that private owners who have the use or right to their property restricted by Federal government regulations shall be entitled to be compensated whenever the loss of value is measurable and non-negligible. A "taking" might be presumed whenever a 10 percent loss occurs.

The Fifth Amendment to the United States Constitution holds that no private property shall be taken by government for public use without just compensation being paid to the owner. In the past most cases requiring compensation arose when governments condemned and seized land in toto for highways or public buildings.

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[29] Hopkins, *op cit.*

[30] *The 1979 Joint Economic Report*, Joint Economic Committee, Congress of the United States, March 22, 1979, pg. 50.

In recent years, there has been an explosion of regulatory takings in which the use or rights of property have been restricted by the Federal government with no compensation being paid. Farmers have been told that they can no longer grow crops because their property has been designated as a "wetland." Owners have been told they cannot build a house on their own land because it might disturb the habitats of certain species.

If the Federal government, for example, wishes to create a public park, it should purchase the land outright. Or if it wishes to keep a parcel of land in its natural state, it can purchase an easement from the owner that prohibits or limits development. It should not place restrictions on the use or rights to property, for example, banning construction of dwellings, without paying.

The requirement that losses of property to be "measurable and non-negligible" would tend to weed out small, nuisance suits against the government. But it would leave open the right to seek compensation in cases where losses might be below 10 percent of the property's value but still substantial, for example, in the case of a large enterprise.

Risk Assessment and Cost/Benefit Analysis: Federal regulations purporting to protect the public health and safety currently are in a state of chaos and confusion. Bureaucrats act in arbitrary ways, destroying the lives of citizens and leaving their victims with little recourse before the law. Regulations often bear little relationship to either the risks or danger they purport avert. In many cases millions or even billions of dollars in costs are imposed on taxpayers or the economy in cases where virtually no risk exists. Little attempt is made to target scarce funds at real dangers. Other risks or damage created by regulations are ignored, as are more efficient means of achieving desired public goods. And little or no attempt is made to balance the social benefits that supposedly will result against the damage done to the economy, the loss of jobs or other adverse effects of a policy.

A good strategy to help the public and policy makers alike judge which regulations are truly in the public interest and which are not is to require that all proposed legislation considered on the floor of Congress shall be accompanied by a CBO study of 1) the degree and probability of risk to the public health and safety targeted by the legislation, 2) the costs associated with implementing and complying with the measure, and 3) the effects on the economy, including GDP growth, job loss, prices and other economic factors of the measure. A similar report, including a consideration of more effective, less costly alternatives, should be provided by OMB for all new regulations promulgated by the Executive Branch.

TAX POLICIES FOR ECONOMIC GROWTH

The structure of the tax system can alter economic decisions relative to what they would otherwise be in the absence of a tax. Economists refer to a tax system that does not materially affect economic decision-making in a market economy as "neutral." Ideally, a neutral tax system would not change incentives, resource allocation or otherwise deflect market forces from what they would be in the absence of taxation. As a practical matter, complete neutrality is probably an unattainable ideal. However, a neutral tax system is one that distorts market decisions as little as possible.[31]

Income Taxation and Tax Neutrality

Under an income tax, saving and investment is usually taxed twice: once out of income, and again on the return to saving and investment. If the investment earning derives from a corporate dividends, that income is taxed a third time by being subjected to the corporate income tax before it ever gets back to the individual.[32]

By contrast, consumption is taxed only once as income. The double taxation of saving and investment raises its price relative to consumption, and thereby undermines the incentive to save and invest. The double taxation of saving can be removed by taking either the amount of new savings, or alternatively the return to saving, out of the tax base. The two methods provide an economic incentive of equal value, assuming the same tax rate is applied to current and future years. The triple taxation of dividend income can be eliminated by full integration of the corporate and individual income taxes or less comprehensively by expanding the dividend-received deduction so that the third layer of taxation is removed completely.

This tax bias against saving and investment takes a variety of forms in an income tax system. Though sometimes referred to as the "double taxation" of saving and investment, the cascading effects of many tax provisions result in a high degree of multiple taxation. For example, the stream of corporate income paid as dividends to shareholders has already been subject to corporate income taxes and capital gains taxes, a variety of state and local taxes, and other fees and charges, before it can even be taxed as personal income. After distribution to shareholders, this stream of income is subject to Federal and usually state personal income taxes, and if saved, the return will be taxed yet again.

[31] Ture, Norman B., *An Agenda of Tax Changes for Growth, Competitiveness, and Efficiency*. A discussion presented to a Policy Conference of the NFIB Foundation and The Institute for Research on the Economics of Taxation, October 30, 1991.

[32] *Ibid.*

The bias against saving and investment in a pure income tax system can be reduced by limiting the multiple taxation of saving and investment. For example, even under current law, the double taxation of personal saving for some taxpayers is limited by permitting IRA deductions for qualifying contributions; only IRA withdrawals are taxed. By stripping away at least part of the double taxation of saving, the price of saving relative to consumption is reduced, and some measure of tax neutrality is restored.

Similar effects are obtained by the current tax treatment of 401(K) plans, certain annuities, pension funds and other forms of saving and investment at least partially shielded from multiple income taxation. As a result, our "income" tax system is not really a pure income tax, but something of a hybrid.

Many economists advocate expanding the tax deductibility of private saving beyond that in current law. For example, IRA contribution deductibility ceilings could be raised, IRA tax benefits extended to all taxpayers, and withdrawal restrictions relaxed. If the tax code permitted unlimited deductible contributions available to all, taxing these funds only when withdrawn, the result would be to transform the personal income tax into a kind of cash flow consumption tax. Movement in this direction would provide a number of economic and social benefits to taxpayers.

First of all, tax neutrality would be advanced, as the price of saving relative to consumption was reduced. By lowering the price of saving, incentives to save and invest would be improved. The current personal savings rate, at about 4 percent, is low relative to its level in the early 1980s when IRA deductibility was less restricted than now. Contrary to the political criticism of the time, the personal savings rate in the 1981-86 period averaged 7.3 percent. To the extent the current tax code is reducing private saving, it is also reducing investment in the latest capital and technology available, thus undermining long-term economic growth.

In addition, encouragement of personal saving would have important social benefits. A middle class family could easily accumulate tens of thousands of dollars over a relatively short period of time. These reserves would enhance their economic security by providing funds for retirement as well as for dealing with unforeseeable problems such as sickness or unemployment. A middle class composed of families permitted to become more secure and self-reliant is preferable to a situation where too many families feel insecure and unable to cope with the contingencies of life without extensive government assistance.

Tax treatment of business investment analogous to IRA deductibility would permit a deduction economically equivalent to expensing. This would improve the incentive for business saving in a way similar to that provided by tax deductibility of IRA contributions. This would be especially beneficial for dynamic, rapidly growing firms with depreciable assets, and their employees, whose productivity would be enhanced.

Another tax change conducive to improving the climate for growth and innovation would be the inflation indexation of capital gains basis. By taxing the inflation component of capital gains, the effective capital gains tax rate is raised far above the statutory tax rate. There would appear to be broad bi-artisan support for this reform, variants of which have been included in tax bills sponsored by members of both parties.

There are a number of other measures that could also be considered to reduce the existing tax bias against saving and investment. However, the main point is to change the direction of policy to one of increasing saving and investment in human and physical capital, instead of taxing them ever more heavily. While many policy-makers in Washington bemoan the low personal savings rate, they continue to support policies that aggravate the tax bias against saving and investment even more. If one is serious about increasing the rate of private saving and investment, improving productivity and income growth, and permitting more economic security for American families, fundamental reform of current tax policies will be an urgent priority.

The current policy of the Clinton Administration, to deepen the tax bias against private saving and investment while substituting politically controlled investment, will not contribute to economic growth over the long run, but will undermine it.

CONCLUSION

America will make significant progress in solving its problems only when private institutions and markets regain the moral, legal and political authority that has been ceded to government. In order to reinvigorate private institutions and markets, citizens will be called upon to make a sacrifice, not the self-defeating sacrifice asked of them by liberal politicians who continually ask for more private resources and more public control of private institutions, but rather citizens will be called upon to sacrifice their dependency on government.

Sacrificing a dependency on government means citizens will be called upon to take a risk and to give up some of their government entitlements and special protections. In exchange, citizens can be offered an escape from the certain pain that will come with the slow disintegration of the welfare state. Instead, Americans can be presented with an opportunity to enjoy the fruits of freedom and prosperity that only private institutions and free markets can deliver. The first step toward this end is political leadership that helps citizens rediscover a faith in their private institutions and free markets.

Regaining that faith will not be easy. For over 50 years now, liberal, activist government has worked to undermine citizens' faith in their private institutions and free markets. Political leadership will be required to convince citizens that they can reasonably take this risk with a real promise of success. And, that political leadership -- political entrepreneurialism really -- will be risky. Political leaders will have to

risk the full onslaught of the welfare state establishment as it seeks to protect itself from a revival of private institutions and markets. Political leaders who call for a renewal of faith in America's private institutions will be labeled blind ideologues and their efforts will be derided as extremism. Embarking along this long-neglected path, as opposed to continuing down the rutted path of welfare statism, will not be easy, and it will not be painless -- not for citizens and not for the leaders who would blaze the trail. The Republican Party stands ready to provide that leadership.

IV

ECONOMIC REVISIONISM

As the JEC/GOP members have pointed out in the past, the economic history of the 1980s has been misrepresented for political purposes. This economic revisionism has treated the longest peacetime expansion in U.S. history with its 20 million new jobs as an era of grim hardship and a "decade of greed." The purpose was political -- to portray the Reagan-era policies of marginal tax cuts, spending restraint and regulatory curtailment as ruinous economically as well as suspect morally.

The campaign of economic revisionism implies that those who benefitted from the 1980s did so improperly, even though an objective analysis of the data reveal that income gains were enjoyed across the board. Recent news accounts remind us that wildly successful financial speculation and corner cutting by a favored few occurred in the 1970s, and in other decades as well.

Most Americans do not condemn economic success as intrinsically immoral, rather they aspire to it themselves. Moreover, the frailties of human nature that may lead to unethical behavior in many aspects of life are not confined to any particular decade. As pointed out in Chapter III, unethical behavior thrives and tends to persist in those circumstances where government and private institutions become too closely connected and intertwined. Greed is a personal sin, and a free and open market inevitably punishes it. Greed thrives when government is powerful enough to protect the greedy from market forces.

Unfortunately, the Clinton Administration's 1994 budget submission continues the practice of misrepresenting the 1980s, though a few rays of candor gleam through in the less partisan report of the Council of Economic Advisers. According to the new CEA report prepared by Clinton Administration economists, "It is undeniable that the sharp reduction in taxes in the early 1980s was a strong impetus to economic growth." Nonetheless, the budget submission and other Administration documents continue to distort the economic record.

The cornerstone of the Clinton strategy in framing key economic and budget issues is to subtract from the prosperity of the low tax 1980s the effects of the high tax 1990s, and label the result the "last 12 years" or the "Reagan-Bush" years. While this is an understandable partisan position, it should not be permitted to obscure the fact that the policy direction, pace of job creation, and income growth of the 1980s and early 1990s were fundamentally different from one another.

After the 1981 tax cut, income tax rates were sharply reduced for all taxpayers, median family income grew 13 percent, and about 20 million jobs were created. After the 1990 tax increase promoted by Office of Management and Budget (OMB) Director Richard Darman, in collaboration with most congressional Democrats, tax rates were increased, incomes declined, and job creation plunged. While the linkage between policy changes and economic performance are controversial and to some extent uncertain, it is clear that the policy regimes of the 1980s and 1990s were very different and produced quite different economic outcomes. It is simply disingenuous to combine the economic performance of the 1990s with the policies put in place almost 10 years earlier while ignoring a much more recent shift in policy that more plausibly explains a more recent shift in economic performance.

In this chapter we analyze the various techniques of statistical distortion most commonly used to allege the middle class was harmed in the 1980s. The first technique is to move the starting point of the 1980s well back into the end of the Carter Administration in order to depress measured income growth. Second, defective Congressional Budget Office income data are often used which purport to show that the incomes of the low and middle income families declined in the 1980s. Third, many income data are used on the assumption that families classified in a given fifth of the income strata remain there over fairly long periods, which is not true for most families. Finally, in the last section of the chapter a number of tax and budget myths are examined.

1980 Income Meltdown Dominates 1979-89 Time Frame

To date much of the analysis of income trends during the 1980s use 1979 as the starting point. 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 the 1980s, 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 a single year, 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.

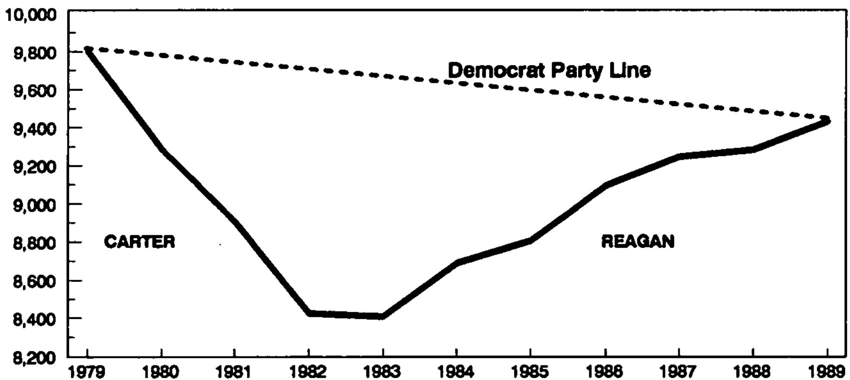
A review of the data shows that the 1980 drop in income for the bottom quintile comprises 139 percent of the income decline attributed to the whole 1979-89 period (see Chart IV.1). However, the average income of this group increased between 1980 and 1989. The scenario that there was a straight drop in 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.

Chart IV.1

"DEMOCRAT PARTY LINE"

Real Average Income of the Bottom Fifth, 1979-89

In 1989-$



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 year of the Carter Administration. This 1980 decline is 140 percent of the income decline over 10 years. The following 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.

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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."[1]

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.[2] Of course, these errors 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 some as late as 1993. Furthermore, the CBO reports on this 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.

Middle Class Shrinking Upward

One way to review income trends is to examine the shares of families falling into low, middle, and high income categories over time. Table IV.1 shows that the proportion of families earning less than $15,000 annually declined during the 1980s, while those earning over $50,000 increased. It is true, as critics charged, that the middle class seems to have shrunk as a proportion of the whole, but this reflects the fact that many of them moved above the $50,000 income threshold. Between the early 1980s and 1989, the proportion of families with incomes over $50,000 jumped by 7 percentage points, to 29.0 percent.

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[1] JEC/Democrat Press Release, 1990.

[2] 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.

Table IV.1 — **Percent of Families by Income Group**
(income defined in 1989-$)

Year	Low Income (Under $15,000)	Middle Income ($15,000-$50,000)	High Income (Over $50,000)
1973	18.2%	61.2%	20.5%
1976	19.1	61.1	19.9
1977	19.1	60.0	21.1
1978	18.4	59.1	22.6
1979	17.6	59.1	23.2
1980	18.8	59.3	22.0
1981	19.9	58.6	21.6
1982	20.7	57.6	21.5
1983	21.0	56.7	22.3
1984	20.2	55.8	24.0
1985	19.7	55.5	24.7
1986	18.9	54.5	26.6
1987	18.3	54.2	27.5
1988	18.4	53.5	27.9
1989	18.0	52.9	29.0

Source: Bureau of the Census.

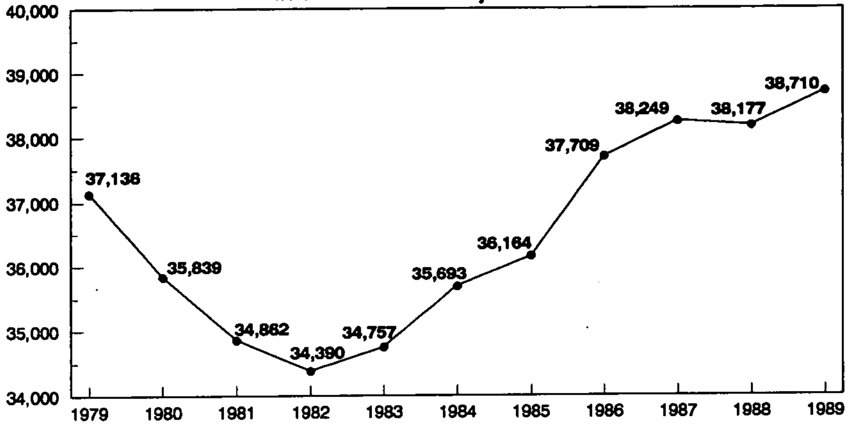
The American economy is essentially an open system characterized by fluid movement of families up and down the income ladder. This movement renders the common ranking and division of families into income strata of quintiles or deciles meaningless for examination of income changes of actual families over time. The method used in the table above avoids this problem. It does not pretend to portray income changes of particular groups of families, but only to illustrate the broad progress in family income over time.

Median Family Income

As a candidate, Bill Clinton contended that the income of the middle class declined during the 1980s. He was wrong.

Real median family income is perhaps the best single measure of the economic progress of the middle class. Real median family income is a standard income measure published by the Census Bureau, and is not affected by disproportionate changes at the high or low ends of the income dispersion. The median is useful for showing changes in the middle range over time, and obviously does not purport to measure the same

people over the years. Chart IV.2 shows the decline in median family income which started in 1980, and the upward trend during the 1980s expansion.



The $1,297 decline of real median family income in 1980 is one of its worst declines ever. During the economic expansion of the 1980s, real median family income climbed from $34,390 in 1982 to $38,710 in 1989, a 13 percent increase. According to this standard measure, middle class income increased during the 1980s. While this increase is not the strongest on record, it does reflect solid progress.

DEFECTIVE CBO FAMILY INCOME DATA

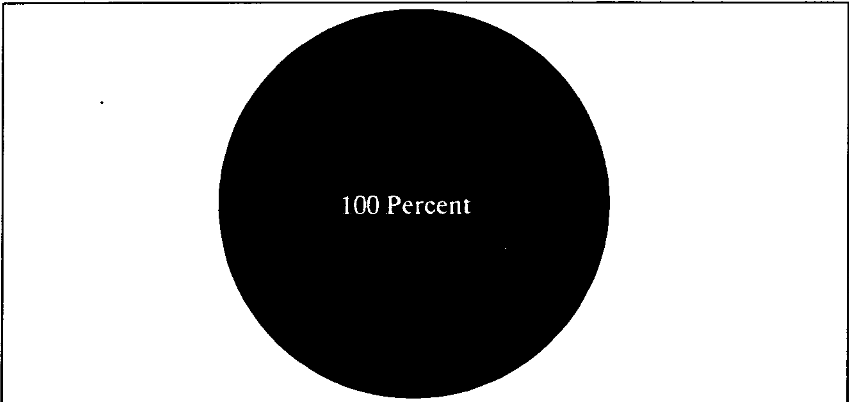
Bill Clinton's statements about the middle class income trends were based on a CBO measure of what the agency calls "family income," though this measure really is not based on the family unit, and strictly speaking doesn't measure income. A two-year research project conducted by JEC Republicans on the CBO family income measure uncovered and disclosed a number of analytical and statistical errors. Since these CBO data have driven the debate over economic policy and politics in recent years, it is important to realize why they are invalid, and that they have apparently been

discontinued by the CBO. The key CBO data in question were created in 1987 at the request of a leading critic of tax reduction policies, and gradually came to drive economic policy and politics through the 1992 election.

These faulty CBO family income data have provided a pseudo-scientific basis for the class warfare campaign pursued over the last several years. These CBO family income data are the foundation for the innumerable assertions that the rich had spectacular income gains in the 1980s, while the incomes of the middle and lowest fifths of families declined. As noted by the liberal Urban Institute, "This is simply not true."[3] A more recent twist, used by Bill Clinton in the 1992 campaign, has been the argument that the defective CBO income data show that 70 percent of the income gains during the "1980s boom" went to the top 1 percent, without disclosing that the same data show that the top 1 percent got 100 percent of the income gains during the Carter years 1977-80 (see Chart IV.3). Thus any shift was from a total concentration to a much broader sharing of income gains in the 1980s, exactly opposite of conventional wisdom.

Chart IV.3

Share of Income Gains
Accruing to Top 1 Percent
1977-80 (Carter Years)



Source: CBO

[3] Sawhill, Isabel, and Mark Condon, "Is U.S. Inequality Really Growing?," *Policy Bites*, June 1992, Washington, D.C., pg. 3. See also Thomas Sowell, "Lies, damn lies and politicized statistics," *Forbes*, July 8, 1991, and Warren Brookes, "The unfairness of CBO's 'fairness model'," *The Detroit News*, March 27, 1991.

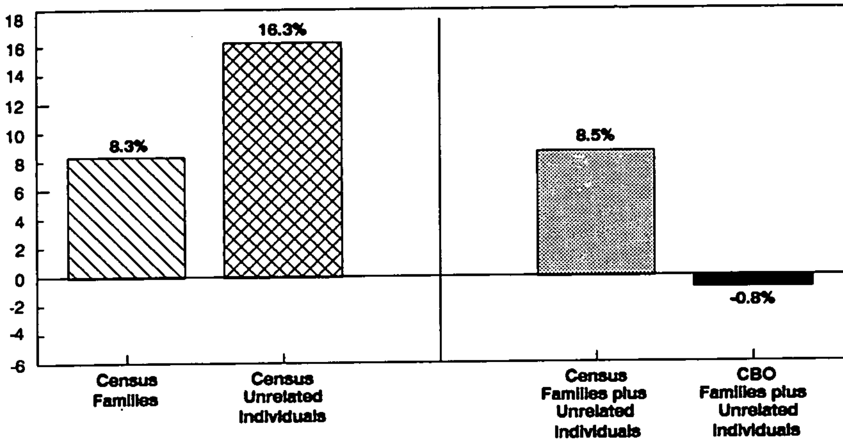
In addition to the numerous technical defects noted in previous JEC/GOP publications,[4] there is a more systematic bias in the CBO family income data relating to the definition of families and the way members of these "families" are assigned to the quintiles ranked top to bottom and grouped into fifths, or quintiles. **This bias is sufficient to convert a positive trend of income gains in the lower three Census quintiles between 1980 and 1989, to one in which incomes in the bottom three CBO quintiles are falling.** This is very odd, since most of this income measured by CBO in these quintiles is derived from the Census Bureau. This particular distortion of the CBO data probably has more to do with the CBO methodology of defining and reshuffling families among quintiles than with the mismeasurement of income per se.

The distorted CBO data also are used to argue that the income of the middle class has fallen during the 1980s, a statement which simply is not correct. These CBO data are the basis of the Clinton contention that middle class "income went down." An examination of the Census data on the average family income of the middle quintile provides an interesting illustration of the basic problem.

Chart IV.4 shows that the real average family income of the middle quintile increased 8.3 percent between 1980 and 1989. During the same period the average income of unrelated individuals increased about twice as fast, at a rate of 16.3 percent. However, when CBO combines these Census data on families and unrelated individuals along with IRS information, it does so in a way that depicts the average income of the middle quintile of "families" declining by about 1 percent.

[4] See *Distorting the Data Base: CBO and the Politics of Income Redistribution*, April 1991, *Income Mobility: Open Society or Caste System?*, January 1992; *Massive CBO Errors in Capital Gains Projections*, February 1992, and *Cooking the Books with CBO Family Income Data, Economic Policy Update* prepared for Rep. Dick Armey, (R-TX), Joint Economic Committee, April 1992.

Chart IV.4



Source: Census Bureau and CBO.

This is clearly an absurd result. The average real incomes of these two distinct groups, individuals and families, both post significant gains in the middle quintile. The income averages for individuals actually grow nearly twice as fast as those for families; however, when CBO adds single individuals to the CBO data base, it is done in such a way as to create an apparent decline in "family" income. CBO has added a group with faster growing income to another group with income growth and by so doing managed to convert two positive changes into a negative one. This grossly misleading result is driven by the way persons are reshuffled by CBO and by the exaggeration of growth in the number of families.

CBO's Fabricated Family Boom Erases Income Gains

In allocating the increase in total family income over a period of time, it's perfectly reasonable to separate that income gain which is simply derived from the increase in the number of families and that which reflects a rise in average family income. The more income that's attributed to the increase in the number of families, the less left over to attribute to average income growth per family. In other words, **exaggerating the growth in the number of families artificially depresses the average income growth per family. This is exactly what CBO is doing.**

During the years 1980-89, the number of families grew 9.6 percent according to the Census Bureau, and 15.9 percent according to CBO. The CBO figure reflects a rate of growth 66 percent faster, due to the peculiar CBO definition of "family" to include single persons. By exaggerating the increase in the number of families since 1980, CBO

depresses average income growth per family. This is a major part of the explanation for the fact that CBO average family income data show declines in the lower three quintiles between 1980 and 1989, while the Census data show increases in all three quintiles. These cannot be driven by the total amount of income increase, which is largely the same Census data, but by how this income is divided among a different number of families.

The Census Bureau data on household income do combine family income and that of unrelated individuals. However, two or more single persons living together are counted as one household by the Census Bureau. In 1989, the number of CBO families, at 102 million, amounted to 9.3 percent more than the Census total of households at 93.4 million. Roughly the same amount of income divided by a 9.3 percent larger number of households will reduce average "family" income by about 9 percent, relative to what it would otherwise be. By lowering 1989 average income, the change in income relative to 1980 can be flattened or even converted into apparent income declines.

The CBO family income data are systematically distorted in a way which must depress income growth. CBO staff have admitted that these data are "deceptive." Though they have now been discredited by the JEC/GOP studies,[5] these CBO data have misled the public for many years and have had an extremely adverse impact on economic policy.

CBO's Newspeak: Single Persons as "Families of One"

The CBO definition of family in average family income contradicts common usage if not common sense. Single persons, which the Census Bureau calls "unrelated individuals," are defined by CBO to be "families of one," and their incomes are included in family income measures. Given the growing proportion of the population who are single, their inclusion will affect the measurement of income over time. Their significance is not trivial: 46.1 percent of the CBO "families" in the bottom CBO quintile consisted of single persons in 1989. It is not surprising that single individuals would be over-represented in the bottom quintiles since they tend to have lower incomes than family members. In any event, to designate a group of households, almost half of which are single, as the bottom fifth of "families" is stretching logic to its breaking point. At least this peculiar definition is disclosed, unlike other CBO methodological innovations.

This inclusion of single persons is given more weight by the novel way CBO adjusts income for family size for the purpose of ranking persons among the quintiles. For example, in adjusting family income, a poverty measure may be used setting the poverty threshold at $6,415 for one, $8,208 for two, $10,047 for three, $12,883 for four (in 1991 dollars), and so on, to account for economies of scale in living costs. "Family"

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[5] The most defective CBO data central to the debate have evidently been discontinued, as they did not appear in the Ways and Means Committee *Green Book* in 1992. This clearly amounts to a tacit admission that these CBO data were indeed flawed and inaccurate, as JEC Republicans had said for several years.

income is divided by this threshold to generate an index number used to rank persons by income. This introduces several problems. First, this adjustment for living costs on the basis of family size converts the data from an income measure into a measure of economic well being. Strictly speaking, the basis of the CBO adjustment is not income, but a distorted measure of economic well being. More importantly, in a population characterized by a growing share of single persons (a group which tends to have lower incomes than others), this adjustment further depresses their income for the purpose of ranking and assigning them to the quintiles.

When unrelated individuals are mixed with family members in the CBO data base, the economies of scale pivotal for the adjustment are never applied to individuals even though these economies often exist. In other words, when these individuals live together in order to economize on living costs, these economies are not counted for the purpose of ranking by adjusted income. Economies of scale apply to families who share living quarters, but never to individuals who share living quarters. This is a completely illogical and indefensible procedure.

Thus family members on the one hand and unrelated individuals on the other are assigned to quintiles on fundamentally different bases. This inconsistent classification of persons means that economies of scale are used only if enjoyed within a family unit, but are not applied to groups of unrelated individuals enjoying equivalent economies of scale. Obviously this is a completely arbitrary and nonsensical methodology. Either economies in living expenses should be counted consistently regardless of the social character of the persons enjoying these economies, or they should not be counted at all. Since the CBO ranking of persons is defective, the assignment of persons to quintiles is distorted and valid CBO family income measures cannot possibly result.

Summary of Problems in CBO Income Data

A number of previous JEC/GOP staff studies have explained the severe defects in CBO family income data. These data are important because they were the foundation of the "fairness" issue used to frustrate pro-growth policy initiatives over the last three years. The CBO defects include, among others:

- counting inflation in supposedly inflation-adjusted capital gains income;
- exaggeration of capital gains income while limiting net capital losses to $3,000;
- fully including partnership income while excluding partnership losses as well as rental losses (combined amounting to $100 billion or more in income losses);

- not fully counting capital gains in real estate and pensions accruing to middle class families; and

- completely ignoring income mobility.

In addition, the 1990 election year CBO family income data, distributed on a saturation basis, included a $130 billion overstatement of capital gains which CBO failed to disclose to Congress or the public even though it was also used to evaluate capital gains tax cut proposals. Generally, the effect of CBO errors was to exaggerate the income gains at the high end while understating those at the low end.

CBO resorts to a defective and distorted manipulation of **non-family** households to produce numbers which show that the income of middle class **families** declined in the 1980s. Once the average income of the bottom three quintiles of families appear to be falling, all kinds of absurd manipulations of the fabricated "data" are possible. For example, since the income for the bottom 60 percent supposedly declined, any increases in the top two quintiles can be made to appear that the top percentiles got virtually all the income gains.

This is the basis for the CBO/Krugman/Clinton calculation that the top 1 percent got 70 percent of the income gains.[6] If the income gains of the majority of families were accurately measured as positive, instead of negative, it would be impossible to make up such a "factoid." However, even accepting the CBO fabri-cated data at face value, during the Carter years this percentage was at least 100 percent. Moreover, the only way CBO can show negative results for family income trends during the 1980s is to resort to a defective inclusion of non-family households. CBO staff have admitted that these set of data are deceptive. The question that remains is why CBO would repeatedly inject such deceptive misinformation into the public domain over so many years.

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 better characterize America's 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.

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[6] A March 5, 1992 front page *New York Times* article, inserted multiple times into the *Congressional Record*, framed this issue based on a manipulation of CBO data by Paul Krugman. Unfortunately, space limitations preclude mention of the numerous factual errors in this article, but suffice it to say that even the reported number of families was off by many millions.

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,[7] 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.

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. Chart IV.5 displays the income mobility of the various groups.

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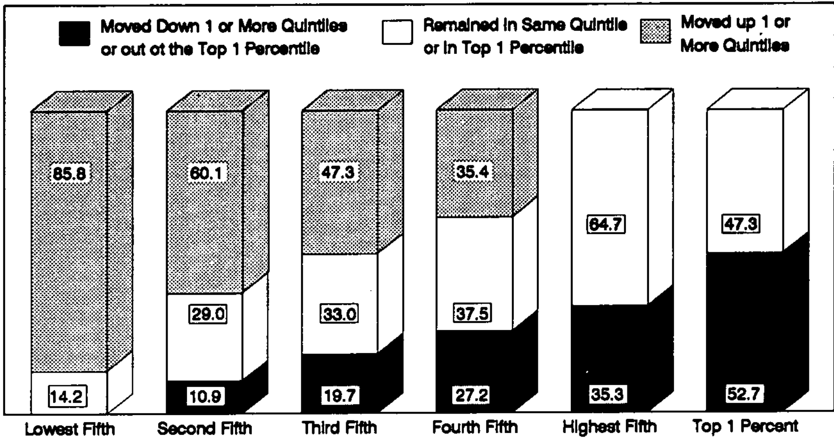
[7] JEC/GOP staff study, *Income Mobility and the U.S. Economy: Open Society or Caste System?*, released by Congressman Dick Armey (R-TX), January 1992.

Chart IV.5 Net Progress in the Bottom Four Quintiles
1979-88



Source: U.S. Treasury.

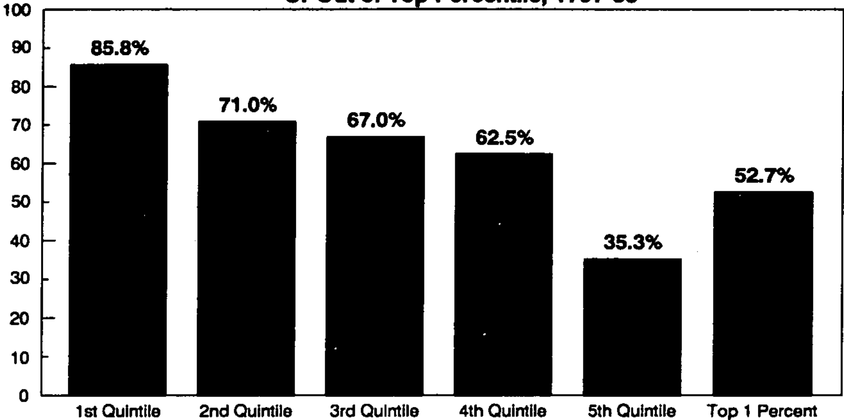
In all but the top quintile, at least 60 percent of filers exited their 1979 income quintile by 1988, with two-thirds or more exiting in the bottom three quintiles. Though much more stability was observed in the top fifth, over one-third had slipped downward to be replaced by others moving up. Even most 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, inter-temporal comparisons of average wages, earnings, or private incomes of quintiles cannot provide meaningful measures of changes in the income of actual 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. Chart IV.6 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.



Source: U.S. 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 IV.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 IV.2 — **America On The Move**

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

Source: United States Treasury.

About 86 percent of those in the first (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 (fifth) 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 (fifth) 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.

BUDGET REVISIONISM

TAX PAYMENTS AND TAX BURDEN SHARE OF TOP 1 PERCENT FALL IN 1991

In 1990, the Congress enacted a tax increase that raised the top statutory income tax rate by three percentage points, with other provisions raising the effective top income tax rate even more. However, instead of leading to an increase in tax revenue, the income taxes paid by the top 1 percent of income earners fell from $115.0 billion in 1990 to $109.8

billion in 1991, a decline of $5.2 billion, or 4.5 percent. One reason for this decline is the fall in the adjusted gross income of these taxpayers from $489.7 billion in 1990 to $456.4 billion in 1991, a decline of $33.3 billion, or 6.8 percent. This decline in AGI would also be reflected in taxable income.

Of course, 1991 tax payments by all income groups would have been some-what affected by the recession. Nonetheless, income tax revenues paid by the other 99 percent of taxpayers (all but the top one percentile) increased from $335.8 billion in 1990 to $337.4 billion in 1991. The AGI of these taxpayers climbed from $297.6 billion in 1990 to $306.0 billion in 1991, an increase of $8.4 billion or 2.8 percent. The basic pattern is clear: Revenues from the top 1 percent declined while the revenues paid by other taxpayers were slightly higher.

One result of this pattern of tax payments is that the share of the income tax payments borne by the top 1 percent declined from 25.5 percent in 1990 to 24.6 percent in 1991. Another way of saying this is that taxpayers below the top 1 percent, those with less than $169,000 AGI, assumed nearly one percentage point more of the tax burden in 1991 than in 1990. So there was indeed a shift in the tax burden, but in the opposite direction from that intended by tax increase advocates, or as projected by the Congressional Budget Office and the Joint Committee on Taxation.

Essentially, the data show that taxpayers' realization of income is inversely related to the maximum tax rates. While the precise break-even point is a matter of some dispute, the recent tax data indicate that it is in the neighborhood of the 28 percent level in the pre-1990 tax law. (State income taxes mean the combined marginal tax rate facing taxpayers would have been higher than 28 percent.) The relationship between changes in tax rates and the realization of taxable income is the most important explanation for the shift in the tax burden in 1991. As emphasized by JEC Members[8] and others for many years, high tax rates increase incentives to avoid realization of income, to invest in tax shelters, or to engage in other tax avoidance strategies. Thus efforts to increase the progressivity of the tax system in the abstract by making the rate structure more progressive produce results that make the actual payment of taxes less progressive. The taxpayers targeted by the higher tax rates are usually engaged in business and investment activities, which gives them considerable discretion about the timing and form of income realization. Among the components of income of the affluent declining in 1991 relative to 1990 were wage and salary income, capital gains, business and professional income, and partnership and S corporation income.

[8] See Republican sections of *JEC Annual Report*, 1986-93.

Tax Rates and Tax Revenues

The most recent IRS data confirm the relationship between excessive tax rates and tax revenues evident for many years. For example, after the broad-based income tax rate reductions of the 1980s cut all tax rates and brought the top tax rate down to 28 percent, the increase in tax payments by the top 1 percent of taxpayers took off, increasing 51 percent between 1981 and 1988, after adjustment for inflation. Table IV.3 and Chart IV.7 displays the average income payments by percentile grouping for tax years 1981-91.

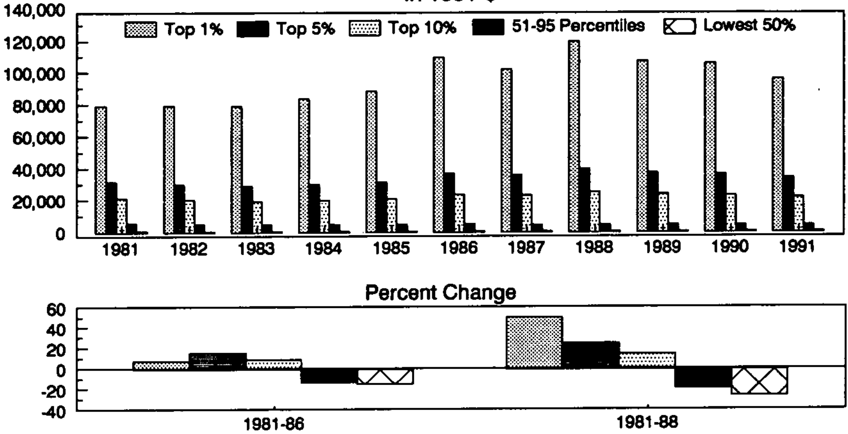
Table IV.3 — **Average Income Tax Payments by Taxpayer Group**
(in 1991-$)

Year	Top 1%	Top 5%	Top 10%	51-95 Percentiles	Lowest 50%
1981	$79,304	$31,633	$21,638	$5,764	$672
1982	79,250	30,101	20,238	5,232	612
1983	79,174	29,041	19,370	4,811	559
1984	83,624	30,083	20,024	4,811	582
1985	88,318	31,411	20,838	4,864	581
1986	109,843	36,701	23,715	5,036	576
1987	102,238	35,763	23,024	4,689	505
1988	119,745	39,658	24,914	4,717	499
1989	107,321	37,406	23,759	4,765	498
1990	106,021	36,567	23,134	4,644	479
1991	96,450	34,131	21,747	4,461	431
Percent Change					
1981-86	38.5%	16.0%	9.6%	-12.6%	-14.4%
1981-88	51.0%	25.4%	15.1%	-18.2%	-25.8%

Source: IRS and JEC/GOP staff calculations.

Chart IV.7 **Average Income Tax Payments by Taxpayer Group**

In 1991-$



Source: IRS and JEC/GOP staff calculations.

The impact of these changes in income tax payments on the income tax burden is shown in Table IV.4. The share of the income tax burden borne by the top 1 percent jumped from 17.6 percent to 27.5 percent, an increase of 10 percentage points. Meanwhile, the share of the income tax burden borne by the middle class (with income between approximately $18,000 and $73,000 in 1988), dropped from 57.5 percent to 48.7 percent, a decline of 9 percentage points. In other words, 90 percent of the increased shift in the tax burden on the top 1 percent was reflected in tax relief for the middle class. As a result of the 1981 tax cut alone, the average family saved about $2,000 annually in Federal income tax payments by the end of the 1980s.

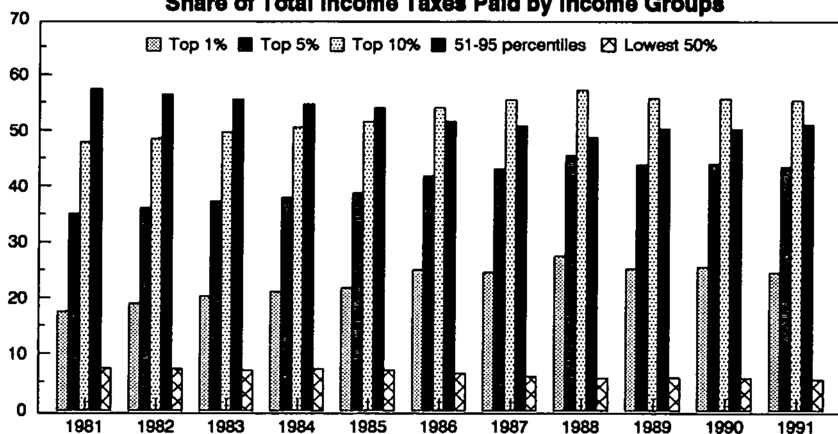
Between 1981 and 1988, the average tax payment of the lowest 50 percent fell 25.7 percent, and their share of the income tax burden declined to 5.7 percent. On the other hand, of the $412.8 billion in personal income taxes collected in tax year 1988, $113.8 billion, or 27.5 percent, was contributed by the top 1 percent of taxpayers. In sum, 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 57.2 percent. Table IV.4 and Chart IV.8 show a massive shift in the tax burden, but its direction is upward onto the shoulders of the high income earners.

Table IV.4 — Income Tax Burden Shifted Towards Wealthy

Year	Top 1%	Top 5%	Top 10%	51-95 Percentiles	Lowest 50%
1981	17.58	35.06	47.96	57.49	7.45
1982	19.03	36.13	48.59	56.52	7.35
1983	20.32	37.26	49.71	55.57	7.17
1984	21.12	37.98	50.56	54.67	7.35
1985	21.81	38.78	51.46	54.05	7.17
1986	25.03	41.81	54.03	51.63	6.56
1987	24.63	43.08	55.47	50.84	6.08
1988	27.50	45.53	57.21	48.74	5.73
1989	25.17	43.87	55.73	50.29	5.84
1990	25.50	43.98	55.65	50.26	5.76
1991	24.55	43.43	55.34	51.08	5.49

Source: IRS.

Chart IV-8



Source: IRS and JEC/GOP staff calculations.

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 CBO and the Joint Committee on Taxation (JCT), 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 data reported in Table IV.3 and Chart IV.8 prove conclusively that CBO and JCT were completely wrong about the impact and even the direction of the tax rate cuts' effects. Actual income tax payments by the top 1 percent increased sharply, even after adjustment for inflation. Oddly, in the 1980s, 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.

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 to the average tax payment in the bottom 50 percent. In 1981 the average income tax payment in the top 1 percent was $117.95 for every dollar of average tax payment in the bottom 50 percent. By 1988 the fairness ratio had jumped to $239.87, an increase of 103.4 percent (see Table IV.5 and Chart IV.9).

Table IV.5 — Fairness Ratio* in Tax Payments

1981	$117.95
1982	129.48
1983	141.69
1984	143.57
1985	152.14
1986	190.85
1987	202.39
1988	239.87
1989	215.61
1990	221.53
1991	223.74
Percent Change	
1981-86	61.8%
1981-88	103.4%
1981-90	87.8%

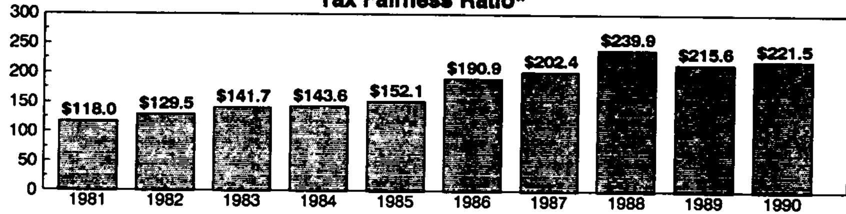
Source: JEC/GOP staff calculations.

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

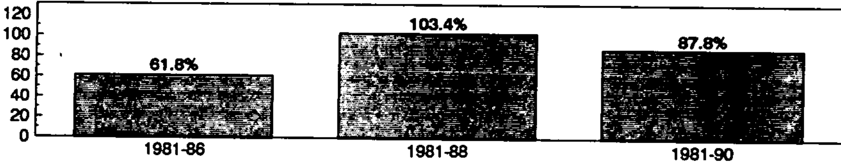
Chart IV-9

Tax Fairness on the Rise

Tax Fairness Ratio*



Percent Change of Tax Fairness Ratio in Selected Time Periods



Source: IRS and JEC/GOP staff calculations.

*Tax Fairness Ratio equals the average income tax payment in the top 1 percent divided by the average tax payment in the bottom 50 percent.

Furthermore, 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 20 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.

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 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.

In short, the IRS data demonstrate that the income tax payments of taxpayers in the top 1 percent rose sharply under the lower rates of the 1980s, increasing their share of the income tax burden, and begin to decline when under the higher rates imposed in the 1990s.

The new IRS data presented here confirm the argument made in opposition to the 1990 income tax rate increase that it would not produce the revenues projected. Instead, the ironic result of a policy driven by class warfare arguments was a decline in the tax revenues derived from the top 1 percent. Moreover, this caused a shift in the income tax burden away from the most affluent and towards middle class taxpayers. Unfortunately, the same faulty premise also drove the policy in raising the maximum income tax rates yet again, with similar results to be expected in coming years. Based upon the historical record it can be safely predicted that under the Clinton tax increases, tax payments of the most affluent will decline relative to others, with more of the tax burden shifting back in the direction prevailing in 1981, when less than 20 percent of personal income taxes were paid by the top 1 percent of taxpayers. Furthermore, the fall-off in income tax revenues will undermine CBO and OMB projections of deficit reduction under the Clinton tax increase.

Revenue Assumptions Under the 1981 Tax Cut

Whether expressed in terms of nominal values or as a share of GDP, there was clearly no plunge in revenue during the 1980s relative to the postwar norms. However, according to the allegation repeated constantly by the tax cut's opponents and much of the media, the deficit of the 1980s originated in the over optimistic revenue projections of the Reagan Administration. The contention is that the Reagan Administration assumed massive revenue feedback effects would result from its tax rate reduction, and the failure of this to actually materialize created huge and growing budget deficits. Essentially, the ideological zeal of the Reagan Administration is alleged to have led it to a leap of faith in revenue projection which left the budget in chaos.

However, the validity of this claim is easily determined by examining comparable CBO material prepared in 1981. The allegation of a rosy revenue scenario collapses

upon review of CBO's 1981 budget update prepared under then-CBO director Alice Rivlin, now a Clinton OMB official. Table IV.6 below compares OMB and CBO revenue, spending, and deficit projections just after the Reagan tax cuts were enacted.

Table IV.6 — **CBO Projects Falling Deficit After 1981 Tax Cut**
(in $-billions)

	1981	1982	1983	1984
Revenues				
Administration	605.6	662.4	705.8	759.0
CBO*	605.0	655.0	698.0	748.0
Outlays				
Administration	661.2	704.8	728.7	758.5
CBO*	665.0	720.0	753.0	798.0
Surplus (+) or Deficit (-)				
Administration	-55.6	-42.5	-22.9	+0.5
CBO*	-60.0	-65.0	-55.0	-50.0

Source: *Mid-Session Review of the 1982 Budget*, July 15, 1981; CBO.
Note: Midpoints of CBO projection ranges. Assumes the spending policies of the First Concurrent Resolution on the Budget for Fiscal Year 1982, with the tax estimate adjusted to reflect the provisions of the Economic Recovery Tax Act of 1981.

A comparison of the CBO and OMB revenue projections shows a very similar revenue path. The OMB projections are slightly higher, climbing to $11 billion over the CBO level by 1984. However, much of this difference is due to higher projected nominal GNP growth. In any event, it is clear that there is no wild optimism reflected in the OMB revenue projections. Unless director Rivlin and her senior staff had covertly prepared an optimistic supply side revenue forecast themselves, a comparable projection from OMB cannot reasonably be regarded as unrealistically high. The CBO document proves that the rosy revenue forecast is simply a myth.

Also notable is the fact that CBO projected shrinking budget deficits after implementation of the Reagan tax cuts. Between 1982, the first year of the 10 percent rate reduction, and 1984, the deficit was projected to decline 23 percent. The OMB numbers are more optimistic, mostly because different assumptions about spending, but both agencies concur that the deficit would go down, not up, after the 1981 tax cuts.

The truth is that the CBO and OMB forecasts were wrong not because both were driven by supply-side ideology, but because neither foresaw the 1981-82 recession. This recession depressed revenues and boosted outlays, pushing deficits over $200 billion. It took five years of economic expansion to get the deficit down to $150 billion or so.

The partisan argument that the Reagan Administration used grossly unrealistic revenue projections is simply false, as shown by the 1981 CBO budget update. The fact that this statement is false will not stop it from being repeated again, but its falsity is easily established by the factual record. If liberal critics of the 1980s will not listen to Republican Members of the Joint Economic Committee, perhaps they will listen to one of their own economists:

> Even in the absence of tax cuts or any military buildup, we would still have faced the extraordinary problem of an exploding deficit because of inflation-swollen entitlements, inflation-boosted interest rats, and post-inflation reduced tax revenues.[9]

REVENUE PROJECTIONS AND CAPITAL GAINS

The inadequacies of revenue estimation in the face of tax rate changes are reflected in the huge errors in official projections of capital gains realizations. As disclosed in a JEC/GOP staff study[10] as early as 1991, the CBO projections of capital gains realizations were grossly overestimated; ultimately these errors amounted to over 100 percent for 1990, 1991, and 1992. By 1992, the CBO forecast error amounted to about $170 billion in capital gains realizations. These shortfalls in capital gains realizations would be associated with revenue losses amounting to over $40 billion annually.

How could a mistake of such a magnitude have been made? A review of the data suggests that a straightline extrapolation of capital gains realizations between 1980 and 1985 would have predicted gains in the neighborhood estimated by CBO in 1991 and 1992. CBO projected that capital gains realizations would be $225 billion in 1989, $254 billion in 1990, $268 billion in 1991, and $287 billion in 1992. The only problem is that the capital gains tax rate had been considerably increased after 1986, and this increase would have a permanent effect on the willingness of taxpayers to realize capital gains. Clearly CBO had failed to accurately take taxpayer behavior into account in making its capital gains projections (see Chart IV.10).

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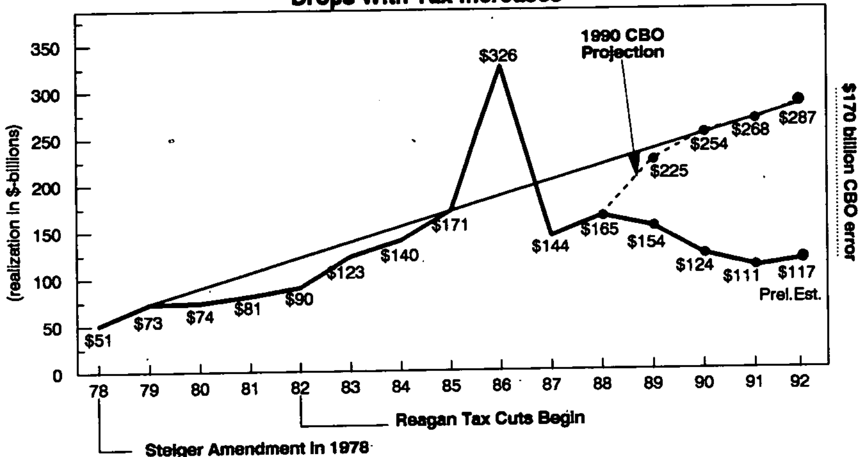
[9] Heilbroner, Robert and Peter Bernstein, *The Debt And The Deficit*, W.W. Norton & Company, New York, 1989, pp. 24-27.

[10] A JEC/GOP study, *Distorting the Data Base: CBO and Politics of Income Redistribution*, prepared at the request of Congressman Dick Armey (R-TX), Joint Economic Committee, April 1991.

Chart IV.10 **Capital Gains Up With Tax Cuts**
Drops With Tax Increases



Source: IRS and JEC/GOP staff calculations.

Note: The 1992 preliminary estimate will probably be adjusted slightly upward as more information becomes available.

These projections were not an internal academic exercise, but were used for the purpose of scoring major tax legislation, estimating Federal revenues, and fabricating CBO's flawed and now discontinued family income data. If Congress set its spending baseline on the assumption that it had $30-40 billion or more to spend annually for the foreseeable future, and if this money failed to materialize, the result would be much higher deficit spending and national debt. Unfortunately, CBO publicly denied the JEC/GOP disclosure that CBO's capital gains mistake would push deficit spending much higher. Congress continued spending on the assumption this was not a problem, until a massive "technical reestimate" revealed a sudden shortfall in revenues.

To many ordinary Americans, a term such as "technical reestimate" of revenues evokes the image of super-computers, computer printouts, and technicians with white coats and sharp pencils. The degree of precision sounds very impressive indeed. However, this precision is merely an illusion. A CBO "technical reestimate" is simply whatever is left after the effect of economic and legislative changes on a revenue projection are taken into account. After what is known is removed, what is caused by the unknown is what is left, and called the "technical reestimate." It is nothing actually measured, but is only the residual of an arithmetic problem. It is the forecast error that cannot be explained away by changes in legislation or the economy. The effect of the "technical reestimate" is to veil errors in behavioral or accounting assumptions behind an intimidating curtain of obscurity. After ignoring repeated JEC/GOP warnings about

its capital gains projections and their effects on revenues, CBO simply swept the subject under the rug with a technical reestimate.

Most Members of Congress probably are still unaware that the Congressional Budget Office had made such a huge mistake. CBO had failed to disclose its huge errors, even though CBO estimates had been used to estimate Federal revenues as well as capital gains tax cut legislation. While CBO initially denied that the errors disclosed in the 1991 study[11] would materially affect revenues as the study argued, it has recently admitted that its failed capital gains estimates were indeed responsible for huge "technical reestimates" lowering Federal revenues. Unfortunately, this was buried in the back of a budget document and its relation to earlier CBO projections was unclear. As far as is known, CBO never had the courtesy to inform sponsors of the 1989 and 1990 capital gains legislation that CBO and JCT had evaluated these proposals using a tax base which was overstated by over 100 percent.

This episode in revenue estimation highlights how important behavioral assumptions are and how large the resulting mistakes can be if incorrect assumption are made.

Budget Deals and Budget Projections

Over time there have been several attempts to reduce deficit spending by heavy reliance on tax increases. The historical record shows that even after several of these measures were adopted, the level of deficit spending had climbed to its highest level ever by the early 1990s.

In 1990, the CBO prepared its estimates of deficit spending for the first five years of the 1990s, before adoption of the 1990 budget agreement. As Table IV.7 shows, the projected deficits were much lower than those now projected for those same years after two major tax increases.

Table IV.7 — **CBO Deficit Projections**
(in $-billions)

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

Source: CBO and JEC/GOP section of the 1993 *Annual Report*.

[11] *Ibid.*

These CBO deficit estimates are useful for putting several contemporary issues into perspective. First, the 1990 projections of deficits, forecast on the assumption of no policy changes, would be hailed as major accomplishments had they been the result of a change in fiscal policy. However, after two major tax increases, even the structural deficit for 1995 is far above the 1990 projections.

Second, these projections demonstrate why deficit estimates must be approached cautiously. Changes in the economy and so-called technical factors can dramatically change deficit estimates very rapidly. The underlying assumption made is that policy changes will have no effect on the economy or technical factors. However, in reality economic policy is always made with the expectation from all points of view that some impact on the economy will occur. For example, OMB Director Richard Darman and then-Senator Lloyd Bentsen argued that the economic effects of the 1990 budget deal would be to reduce interest rates and boost the economy, while opponents argued that the economy would sink under the weight of the tax increase. After the tax increase, the economy continued to decline. However, CBO revisions do not take into account any economic effects resulting from changes in economic policy. The CBO assumption is that no policy change will have any effect on GDP growth.

Third, the errors in revenue projections are always fully accounted for by changes in policy, economic assumptions, or technical reestimates. Though superficially this completeness, and the "technical reestimate," look very precise and scientific, in reality they are neither. Revisions to previous revenue forecasts are first made to account for policy changes and changes in economic assumptions. After these adjustments are made, any remaining discrepancy between the current forecast and a previous forecast is simply called the technical reestimate. Thus the "technical reestimate" is in reality not a measure or estimate of anything in particular, but simply is what is left after what is known is accounted for. The remaining errors are dressed up and presented as the imposing-sounding "technical reestimate."

A REVIEW OF FISCAL DETERIORATION UNDER MAJOR BUDGET AGREEMENTS

An examination of the results of the budget agreements reached in recent years provides additional information about the effectiveness of tax increases in deficit reduction. **Here we will analyze the fiscal changes following the major tax increasing budget packages of 1982, 1987, and 1990, relative to expectations. The method used here compares CBO projections provided to Congress at the time of enactment to actual revenue, spending, and deficit totals several years later. The results are consistent with the view that tax increases raise congressional spending while overstating projected revenue collections.** This overstatement of revenues occurs because static revenue estimation does not take into account the negative effects of tax increases on economic growth and employment, and inadequately adjusts for changes in taxpayer behavior. In brief, heavier taxation of workers, investors, producers, and employers will undermine economic growth and their realization of taxable income.

In 1982, Congress passed the first budget resolution, which called for $98 billion in new taxes and $280 billion in savings between 1983 and 1985. The first budget resolution, implemented in part by $100 billion in new taxes under the Tax Equity and Fiscal Responsibility Act (TEFRA), estimated that it would reduce the deficit to $60 billion by 1985. Almost immediately after the enactment of TEFRA, a CBO reestimate found that the deficit reduction under the budget resolution would be much less than initially projected, but still would cut the 1985 deficit from $208 billion to $152 billion. However, even so, by 1985 congressional spending was $36 billion higher than the 1982 CBO reestimate, while revenues were $23 billion lower than projected. As a result, deficit spending increased to a level of $212 billion, 40 percent higher than the $152 billion CBO expected, despite the strong economic expansion then underway. Thus a tax increase amounting to roughly $40 billion by 1985 was associated with an increase of deficit spending of at least $60 billion. Of course, if one were to use the $60 billion 1985 deficit projection of the budget resolution as the starting point, the deterioration under TEFRA would have translated into a $150 billion increase in the deficit.

Another example is provided by the 1987 budget summit agreement. CBO estimated that this agreement would reduce the 1990 budget deficit by $40 billion, through roughly half tax increases and half outlay savings. This would have reduced the deficit from a projected $166 billion to the neighborhood of $126 billion. However, three months later CBO reevaluated the budget totals, with $41 billion of technical and economic reestimates wiping out all of the deficit reduction, leaving an increase in the deficit of $1 billion. In other words, the deficit reduction was nullified almost immediately, with the deficit actually increasing slightly a few months after the summit agreement. Unfortunately, the situation continued to deteriorate relative to the reestimate so that by 1990 the level of revenues was $5 billion less than expected while spending was $50 billion higher. Instead of $167 billion of deficit spending, policy-makers were told that the deficit had jumped to $221 billion, nearly a third larger than projected in the reestimate, and 75 percent larger than the $126 billion level expected by policy-makers at the time of enactment.

The best example of this policy failure is provided by the 1990 budget agreement. According to CBO, "the policies in the budget agreement are estimated to reduce the deficit by $35 billion in 1991, $73 billion in 1992, and $163 billion in 1995, compared with CBO's July baseline." The $163 billion reduction for 1995 would virtually wipe out the deficit, according to CBO. By 1995, revenues would amount to $1.429 trillion, outlays to $1.458, and the deficit to a paltry $29 billion. The large purported reduction in deficit spending included $60 billion in debt service savings scored by CBO, over 10 percent of the $496 billion total.

Fortunately, it is not necessary to wait until 1995 to demonstrate how far this scenario strayed from fiscal reality. In January 1993, CBO estimated that revenues would be $138 billion lower than projected, while outlays would be $117 billion more. Instead of a 1995 deficit of $29 billion, the January 1993 estimate was $284 billion, an amount 879 percent higher. Under the 1990 budget agreement the level of deficit

spending estimated for 1995 had jumped from its 1989 level of $152.5 billion to $255 billion in 1993.

CONCLUSION

In the second agreements -- 1982, 1987, and 1990 -- each were presented as measures that would sharply reduce deficit spending relative to CBO projections. However, the budget data show that deficits increased sharply in the wake of each of these tax increasing measures, as spending went higher than expected and revenues fell short. Under each of these tax increasing budget packages, the deficits three years later would reach new record highs. As tax increase opponents had predicted, the promised result of much lower deficit spending simply did not occur.

For example, in 1990 opponents of the budget deal pointed out that it would fail by damaging the economy and encouraging more congressional spending. In addition, early in 1991, a JEC/GOP staff study[12] also pointed out that revenue growth projected under the budget deal was exaggerated by CBO's grossly erroneous capital gains estimates, which overstated income tax revenue by well over $20 billion annually. Subsequent events demonstrate that opponents of the budget deal had a more accurate view of fiscal reality than did CBO. In January 1993, CBO felt it necessary to explain away its wildly inaccurate budget forecast under the budget deal. Indeed, it seems that the economy didn't perform as expected under huge tax increases, Federal spending was higher than expected, and that taxpayers failed to realize capital gains under sharply higher tax rates. These rationales can be used to explain away policy failure, but they cannot make a failed policy successful.

The unrealistic CBO assumptions that economic performance is unaffected by higher tax burdens, that capital gains will be realized at high and growing levels regardless of higher tax rates, and that tax increases will not stimulate more Federal spending, have affected the accuracy of CBO budget projections. However, the existence of these problems does not change the bottom line. The historical record shows that tax heavy budget packages do not produce the net outlay savings or revenue increases promised to reduce the deficit.

Any CBO estimate that the Clinton tax and spending package will reduce deficit spending must be evaluated in terms of the consistent failure in the past to accurately project even the direction of change in the deficit under similar policies.

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[12] *Ibid.*

APPENDIX

Table A.1 suggests the long-term difficulties for the U.S. economy. As economists recognize, economic growth has slowed sharply since the early 1970s. Before 1973 real hourly compensation grew 3.1 percent per year but has averaged only 0.5 percent per year since. At such low rates of growth for real compensation and productivity, many Americans inevitably suffer a decline in their living standards. Table A.1 also shows that the unemployment rate increased nearly two percentage points since the early 1970s. Annual growth rates for the money supply and price inflation have doubled, Federal spending as a share of GDP rose from 18.4 to 22.5 percent, and Federal deficits rose from 0.5 to 4 percent of GDP, so the higher spending was nearly all financed by borrowing. Since the Federal deficit is largely financed by savings which are no longer available for investment in productive capital, capital per hour of labor grew 3.3 percent annually between 1948 and 1973 but only 1.8 percent since 1973.[13]

Table A.1 — **Economic Performance Before and After 1973**
(average annual percent)

	Annual Growth in Real Hourly Compen-sation	Civilian Unemploy-ment Rate	Growth of Ml	Price Inflation[a]	Federal Spending as Share of GDP	Surplus or Deficit (-) as Share of GDP
Truman	3.1	4.3	2.3	3.2	15.5	1.1
Eisenhower	3.5	4.9	1.6	2.0	18.6	-0.6
Kennedy	3.0	6.0	2.9	1.1	19.0	-0.9
Johnson	3.3	4.2	5.2	2.8	19.1	-1.1
Nixon	2.1	5.0	5.9	4.8	19.8	-1.1
Average	**3.1**	**4.9**	**3.4**	**2.8**	**18.4**	**-0.5**
Ford	1.0	7.3	5.2	8.4	21.1	-2.8
Carter	-0.4	6.5	7.5	8.3	21.4	-2.5
Reagan	0.7	7.5	8.6	4.4	23.3	-4.4
Bush	0.4	6.2	7.0	3.6	22.9	-4.2
Clinton	0.8	6.7	10.1	2.4	22.4	-4.0
Average	**0.5**	**7.0**	**7.6**	**5.5**	**22.5**	**-4.0**

[a] GDP price deflator.

Source: JEC/GOP staff calculations from *Economic Report of the President, February 1994.*

[13] U.S. Department of Labor, BLS, Office of Productivity and Technology, August 29, 1991.

What happened back in the early 1970s? People point to three signal events: 1) the energy crisis, 2) the wage-price controls imposed by the Nixon Administration, and 3) the breakdown of the Bretton-Woods monetary system, including abandonment of the final disciplinary link between the dollar and gold. Of these explanations for poor economic performance since the early 1970s, the Bretton-Woods breakdown may be most important. The long-run value of the dollar cannot be reliably predicted and political control over the money supply makes deficit financing of government expenditures relatively easy.

The Reagan era promised to reverse the 1970s trend toward bigger and bigger government and dismal economic performance. In many ways, the Reagan Administration succeeded. It was the longest peacetime expansion in history. Disinflationary policies gradually brought down the rate of price inflation. An entrepreneurial boom was unleashed. Rising regulation was reversed, tax rates were lowered, some forms of Federal spending were reined in, and eventually, total government spending increased less rapidly than private output. Even deficit spending declined to $152 billion a year by 1989, leaving the deficit at 2.9 percent of GDP, precisely the same as when Reagan assumed office. As the 1980s came to a close, a balanced budget looked achievable. These accomplishments were remarkable in light of the fact that they were achieved during a period in which an unprecedented number of young and inexperienced workers entered the workforce. If these policies had continued, labor productivity probably would have risen and may well have reached the once-routine growth rates of 2 to 3 percent per year.

Yet the Bush Administration reversed these policies. Erratic monetary policy triggered a recession, government spending exploded, Federal regulation renewed its rapid growth rates, and taxes were hiked. Clinton accelerated this reversal, and a 1970s repeat threatens. Between 1972 and 1982, the Dow Jones Industrial Average fell 10 percent.

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