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THE 1982 ECONOMIC REPORT OF THE PRESIDENT

HEARINGS

BEFORE THE

JOINT ECONOMIC COMMITTEE
CONGRESS OF THE UNITED STATES

NINETY-SEVENTH CONGRESS

SECOND SESSION

PART 2

FEBRUARY 10, 18, 19, AND 24, 1982

Printed for the use of the Joint Economic Committee

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JOINT ECONOMIC COMMITTEE

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Appendix

THE 1982 ECONOMIC REPORT OF THE PRESIDENT

WEDNESDAY, FEBRUARY 10, 1982

CONGRESS OF THE UNITED STATES,
JOINT ECONOMIC COMMITTEE,
Washington, D.C.

The committee met, pursuant to recess, at 10 a.m., in room 6226, Dirksen Senate Office Building, Hon. Henry S. Reuss (chairman of the committee) presiding.

Present: Representatives Reuss, Richmond, and Heckler; and Senators Jepsen, Roth, Mattingly, and Proxmire.

Also present: James K. Galbraith, executive director; Louis C. Krauthoff II, assistant director; Richard F. Kaufman, assistant director-general counsel; Charles H. Bradford, assistant director; Betty Maddox, assistant director for administration; and William R. Buechner, Chris Frenze, Kent H. Hughes, Paul B. Manchester, and Robert Premus, professional staff members.

OPENING STATEMENT OF REPRESENTATIVE REUSS, CHAIRMAN

Representative REUSS. Good morning. The Joint Economic Committee will be in order for its further hearing into the economics of 1982, with special emphasis this morning on the impact of Mr. Reagan's economics on income distribution.

This Monday the President presented his budget for fiscal 1983;. carte blanche for the Defense Department, deep cuts in social programs in the midst of a severe recession, and no trimming to the excessive tax cuts for the affluent passed last year. Interest rates are to be kept at exorbitant levels by the projected deficits in each year of the President's term. The projected deficit will exceed the previous record achieved under President Ford, which was $66 billion in fiscal 1976.

A year ago, we were told by the administration that there would be a cumulative surplus of $14.5 billion for fiscal 1983 to 1986. Now this has been revised to a cumulative deficit of $312 billion. All of this is based on a forecast which is widely believed to be as unrealistic as last year's "rosy scenario."

Public reception of the fairness of the administration's program has changed dramatically within the last year. In the ABC Washington Post poll of February 1981, 67 percent said the President cared about all citizens equally; 24 percent said he cared more about upper income people; and 9 percent said he cared more about lower- or middle-income people.

By November 1981, only 36 percent said he cared about all equally; 56 percent said he cared more about the affluent; and 8 percent said he cared more about lower- or middle-income people.

Norman C. Miller, the Washington bureau chief of the Wall Street Journal, no radical journal, in an editorial page piece 2 days ago had this to say:

> * * * It is fundamentally unfair for the administration to concentrate almost exclusively on cutting assistance to the poor while simultaneously providing an excessive array of tax breaks, several of dubious equity, to affluent persons and corporations.
>
> The imbalance of the administration's policies becomes more drastic when one examines it incredibly overstuffed military budget * * *.
>
> President Reagan's budget makes it clear that the needs of our poorest people are his least concern, notwithstanding his pious statements to the contrary. On that count, his budget flunks the test of fairness.

Wall Street Journal, you can say that again.

This afternoon we will hear more about the President's budget from OMB Director David Stockman when he testifies in this room at 3:30.

This morning we have a panel of the Nation's leading experts on the subject of the distribution of income and wealth. They are going to discuss recent trends in distribution, the causes of those trends, the impact of Mr. Reagan's program, and policies to undo the trend toward greater inequality.

I want to commend our witnesses, because they have turned their studies in recent years to what seems to me to be a really fundamental area of economics, the economics of distribution; and I urge them to be fruitful and multiply. We ought to have many, many more of our economic experts zeroing in on this field.

So, this gallant few this morning is very welcome; an I particularly thank Prof. Edward Budd of Penn State: Prof. Sheldon Danziger of the University of Wisconsin—I'm glad you were able to get out of Wisconsin, Mr. Danziger, with all the snow; Prof. Stephen Rousseas of Vassar; our friend Mr. Gary Shilling of A. Gary Shilling & Co., of New York; and Prof. James Smith of the University of Michigan. Prof. William Ryan of Boston College has submitted an excellent statement, but unfortunately he was taken ill this morning and can't be with us; but his statement, like those of all witnesses, will be enrolled on the record in full. Prof. Alan Blinder of Princeton University was also scheduled to appear, but I'm told that Mr. Blinder had shuttle troubles coming down from New York and will probably not be here.[1]

So, thank you very much for being here, and all your statements, as I say, are incorporated into the record. I will now ask you to proceed. Mr. Budd, would you lead off?

STATEMENT OF EDWARD C. BUDD, PROFESSOR OF ECONOMICS, PENNSYLVANIA STATE UNIVERSITY

Mr. Budd. I understand we have 10 minutes, is that right?

Representative Reuss. Yes, but, particularly because of the nonappearance of a couple of our witnesses, the clock will stop if you go a little over.

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[1] Professor Blinder's views are summarized in "The Level and Distribution of Economic Well-Being," National Bureau of Economic Research, Report No. 154, March 1981.

Mr. BUDD. Thank you. I will not read the entire prepared statement. I will try to summarize and paraphrase it in part. It is available for distribution.

I am pleased to see a renewed interest in income distribution and distribution of wealth as represented by this morning's hearings before the Joint Economic Committee. Not only is it important to review the evidence we have on the extent and changes in inequality, but to recognize distribution as an important policy objective to be considered along with other economic objectives, such as efficiency, economic growth, full employment, and price stability, in determining the balance of economic policies.

I will confine my own remarks to trends in the distribution of income, rely on Professor Smith, if he makes it, to discuss the area of wealth distribution. In my data I relied primarily on Current Population Survey [CPS] data, since those are the only ones that are available for the entire postwar period. I start off by showing a chart on the movement of a single-value measure of inequality, the popular Gini concentration ratio, for both families and unrelated individuals, which I refer to as consumer units, and for families alone.

INEQUALITY DECLINED IN THE 1960'S, BUT HAS RISEN LATELY

You can just see by examining that particular chart, at least for consumer units, that there was some immediate postwar fall in the inequality, a rise up to 1960, and then again a significant decline by the late 1960's, and a subsequent rise thereafter.

For the family ratio, we note that inequality, in effect, has declined quite significantly, rose again in the early 1960's, declined in the late 1960's, and from the mid-late 1960's on, when it was around 34 percent. It has now risen to 36½ percent.

Single-value measures of inequality are popular, but I think we learn more by looking at the shares of individual income groups, when those groups are ranked from lowest to highest, and, in this case, for the Bureau of the Census data, split off by quintile. Those are examined in my figures 2A and 2B.

These, in general, show somewhat the same story as the Gini concentration ratio. They show for the very top group, the top 5 percent, a decline in their share up to about the late 1960's and then some small recovery thereafter. For families there was a significant decline, and then their share since about the late 1960's has been approximately stable.

However, the significant thing to notice is the share of the group immediately below them, which I picked out as the 81st through 95th percentile; and you can see from my chart that, at least from the late 1960's on, those shares, both for families and consumer units, have risen. For example, for the consumer units from the late 1960's, when the share was roughly 26½ percent, it's gone to about over 28½ percent, which is approximately close to a 10-percent increase.

Now, this increase has come, if we turn to the figure 5B, has come primarily at the expense of the middle quintile and the second quintile from the bottom. The decline in the share of the middle quintile is particularly evident for the consumer unit distribution, although there is some small decline for families from the mid-1960's. Prior to that, of course, their share had risen slightly.

On the other hand, at the very bottom of the distribution, that share for the bottom quintile, has risen up to about the 1960's and tended to remain pretty stable thereafter.

My figure 3 doesn't really have any more to provide than that. It's a different way of representing the data. It plots, in effect, the mean income of each of these different income groups in dollars of 1967 purchasing power; but it's done on a ratio scale so that one can also determine what's happening to relative shares as well as the mean real income. When those two lines of adjacent shares narrow, then it means that, in my bottom lines there, the share of the bottom group has risen relative to the quintile above it.

The thing that you can see in this graph is that the real income of various quintiles has been roughly stable since the late 1960's on; whereas, in previous years there was a significant rate of growth. For the upper quintiles the real income has continued to grow, although, of course, at a very much reduced rate.

In figure 4, the series on persons below the poverty line, that tells a rather similar story: a deep decline to the late 1960's, with rough stability in the proportion of all persons in poverty since that time.

Now, my prepared statement does emphasize changes in the size distribution of income, but I think it's just as interesting to look at distribution by socioeconomic characteristics. I only had time to work out some of the information for the distribution by age. This represents, in effect, the ratio of the mean median income of those age groups to the median income for the distribution as a whole for about 5 selected years from 1960 to 1980, and you can see there that what in effect has happened is that the median income of the older age groups—I guess I should say middle, since it starts with age 45—has risen; whereas, those below 45 their median relative to that for the distribution as a whole has declined.

DISSUSSION OF UNREPORTED INCOME, OTHER DATA PROBLEMS

I do note in my prepared statement some qualifications to using these data. For one thing, for the uninitiated, in looking at quintile shares, they often interpret those to mean that over the years people remained in the same quintile. And of course, if a person receives a substantial increase or reduction in his income, he may move from one quintile to another. So we shouldn't interpret these data as simply referring to exactly the same individuals in the same quintile.

Second, I note in my statement that the CPS has certain deficiencies in it, particularly in terms of the underreporting and understatement of income. The means I report in one of my figures are probably understated by as much as 10 percent on the average. And there is a bias in those with respect to the particular income group, particularly the top.

For example, in a study we did at BEA we found that the share of the top 5 percent would have been increased by as much as 30 percent rather than this 10 percent had we allowed fully for all family personal income in the national income accounts, except imputed income. A second important qualification concerns in-kind income. A substantial amount of emphasis has been placed on in-kind transfers and their rise in recent years, whether those transfers are means-tested or whether they are entitlement programs such as medicare.

But we often overlook the fact that there is a substantial amount of other income, noncash, that we ought to allow for. For example, in the national income and product accounts we include imputed rent on owner-occupied dwellings, imputed interest, and a few other minor items. But those two alone are not insignificant in size, and they are more unequally distributed than is total money income as a whole.

Another element is fringe benefits to employees, as well as noncash income received by executives. This has also grown very substantially in recent years.

Capital gains are another important element that are not included in the Census distributions. And another element that I think would round out the picture is the failure in these kind of survey distributions, for appropriate reasons, not to include all of corporate products for imputed individuals, only those that are represented in the payment of dividends.

I have always been curious as to how much those would affect shares, and some years ago I made a calculation from another field survey that the share of the top 5 percent would increase by about 6 percent if we took all after-tax corporate income, which would include undistributed profits, and 19 percent if we took all corporate income, since it's an anomaly that the taxes that are paid by all of these groups are included in all shares except for the corporate income tax. It's not clear to me how making all of these inclusions would affect the trend or modify the figures that I have here. It's not even clear how it would affect their levels. That would require a major research project to try to figure that out.

Some progress has already been made in this direction; particularly Tim Smeeding has done a lot of work on this particular problem. However, I think it is evident from my remarks so far that there is a substantial amount that we do not know about the distribution of income, both levels and trends.

REAGAN PROGRAM WOULD CUT DATA ON INCOME DISTRIBUTION

This observation is even truer for the distribution of wealth. Only more and better data will permit economists and analysts to improve their answers on trends in income distribution, the reasons for those trends, and the effects of various policies on them; yet the Reagan administration seems to be headed in precisely the opposite direction, as if it had no interest in preserving the data base that has been so painstakingly built up over many years, much less in considering needed improvements.

BEA has already phased out its work on aggregate estimates of nonmoney income and is in the process of phasing out all its work on the size distribution of family personal income. Census is clearly undergoing budget cuts and reductions in force that makes one concerned about just what programs in the income distribution area will survive, much less what will be their quality.

But one of the biggest losses will be in the income survey development program, previously sponsored and funded jointly by Census, SSA, and ASPE of Health and Human Services, despite a 5-year development program which would have led to a continuing ongoing survey, emphasizing the collection of data on income, wealth, and participation of Federal and State programs, and incorporating many improvements in data collection methods. Funds for instituting this survey were eliminated last summer.

Now it appears that funds and personal needed to complete the processing of the experimental ISDP panel survey for 1979 are also being eliminated. There is now a real danger that government and private analysts will be prevented from getting access to this data, making it impossible for anyone to complete the data processing necessary to create a public use file since the executive branch is unwilling to do it.

In view of the millions of dollars that have been spent on this program in past years, and interest and support of various Government agencies as well as private research workers outside the Federal Government, I do not see how the scrapping of this work and failing to release the resulting microdata files to the public domain can be justified.

One wonders if this administration fears what the data show. Is it true, to paraphrase some common sayings, what they believe that "No data are good data" and "What they don't know can't hurt them." In contrast to all previous administrations, the leaders in this one appear to believe that economic policy can be made and carried out in the dark.

EXPLANATIONS OF CHANGES IN INCOME DISTRIBUTION

I then go on to try to account for these changes that have occurred in the distribution of income. I point out that one of the most important may well be the level of unemployment. There have been a number of studies of this problem, and they have all come up with the finding that increased unemployment increases inequality. And you will know from my first chart that there has been a significant rise in unemployment ever since the middle 1960's.

So far as the inflation rate is concerned, the findings of various investigators, on the other hand, have not found very much of an effect. Those studies are of course earlier, and perhaps more recent ones using later data, if we had it, might indicate other findings.

One factor that I discuss at some length in the testimony concerns changes in the demographic characteristics of the population. Two of the most important of these are the rise in the proportion of unrelated individuals since the late 1960's from about 20 percent to 30 percent; and since they have a greater degree of inequality among themselves and a lower mean income, that may go a long way to accounting for the divergent trends in distribution of consumer units and the distribution of families.

A similar finding is true for female-headed families with no spouse present, which for roughly the same period have risen from about 10 percent of total families to 15 percent of total families. On the other hand, a recent study done by one of my graduate students suggests that the rise in working wives has probably had, on balance, a neutral effect on the family distribution.

A final source I point to are changes in shares, income type shares, in total money income, and that's presented in my final chart, figure 6, and there you will see—I don't have much time to discuss that chart—that those changes in shares have probably, on balance, up to the middle-late 1960's been favorable to increased equality.

The wage share rose, in contrast to the share of self-employed proprietors, where a large share of that income accrues to the upper income groups. The top 5 percent for example, get about a quarter of their income from self-employment income.

Property income has increased somewhat, but not as much as it would have if it were interest alone. The decline in the share of dividends for straight income and royalties has partially offset the rise in interest income; but there is a small rise, probably from the early 1970's on.

Furthermore, there is the rise in transfer payments that I have shown here. You will see the entire postwar period as a whole has been primarily represented in the rise of retirement income, government and private pensions, and social security benefits.

On balance, other transfer payments have probably remained stable, or as my chart would suggest, even declined in importance from the late 1940's. Of course, the share of retirement income has been roughly stable over the past 4 or 5 years, at 10 percent of total money income received by persons.

REAGAN POLICIES WILL WORSEN INCOME DISTRIBUTION

There are only a few parts in the short statement I had on the effect of Reagan policies. I think their effect on social programs is almost self-evident, at least in terms of their direction. We do not have, nor have we performed any studies to determine, the size of those distributional effects. With respect to the turning back of some of those programs to the State, I think that will increase the disparities that we have previously noted in the receipt of a number of these benefits, such as benefits to dependent children.

With respect to the shift in expenditure from civilian to military, I find it much harder to predict, on balance, what effect that will have, even whether it will increase or decrease inequality. But since, presumably, that kind of expenditure falls on a more skilled labor force, particularly professionally trained people, perhaps more capital-intensive, that might be unfavorable to inequality.

With respect to interest rates, I'm sure it's not clear who we are supposed to blame for the current recession or depression—the President or Congress or Paul Volcker. But in any case, we know that a tight money policy will react and have its primary effect on the current level of unemployment, perhaps only later on the rate of inflation, and that increases in unemployment are unfavorable to more equality. The direct effects of high interest rates, apart from their effect on output and employment, I think are harder to predict.

I note, however, in the last part of this statement that we ought not to judge policy solely on the basis of their distributional effects;

that efficiency and growth are also important considerations, although, even by these standards, it's sometimes hard to understand the President's proposal. Why only minor cuts in agriculture price supports program? Why only minor cuts, if any, on water and navigation projects, since economists have been pretty unanimous in their criticism of the efficiency aspects of these programs?

With respect to education, for example, why so much emphasis on trying to stimulate the growth in nonhuman physical capital assets through the tax laws and increased depreciation and not recognize the importance of forming more human capital through continuing loan programs and student aid programs for college students?

Commenting directly on the tax policies would take even more time than I now have, but I would say, on balance, that those will be unfavorable. When you cut income tax rates and reduce the maximum rate from 70 percent to 50 percent for property income, that's bound to reduce inequality of after-tax income, although, as I noted earlier, we know very little about the distribution of after-tax income. The CPS is geared to before-tax income, and I found from my own work that it is exceedingly difficult and costly to estimate an adequate after-tax distribution, although the effect of taxes in some of the literature that I have examined seems to be roughly proportional.

I think it would be desirable to rethink last summer's tax package, and I add in closing what I consider a not so amusing sidelight: that the way things are going we are not even going to be able to use personal income tax data to get a better estimate of property income, since not much of it is going to get on those forms. It's been argued that not very much of that shows up now, but even less will.

Thank you very much, Mr. Chairman.

[The prepared statement of Mr. Budd, together with the article entitled "Killing the Bearer of Bad Tidings," follows:]

Prepared Statement of Edward C. Budd

I am pleased to see a renewed interest in the distribution of income and wealth, as represented by this morning's hearings before the Joint Economic Committee. Not only is it important to review the evidence we have on the extent of and changes in inequality, but to recognize distribution as an important policy objective, to be considered along with other economic objectives, such as efficiency, economic growth, full employment, and price stability, in determining the balance of economic policies.

I will confine my written statement to trends in the distribution of income, deferring to Professor Smith's expertise in the area of wealth distribution. My data are drawn from the Current Population Survey, which, despite its deficiencies, is the only continuous series on the distribution of income in the postwar period. The upper panel of my first chart (Figure 1) summarizes the postwar trend in inequality in the distribution of total money income (TMI), as represented by a single-value measure of inequality (the Gini concentration ratio), separately for families and for consumer units (the sum of families and unrelated individuals). For consumer units overall inequality has fluctuated within a range of about 5 percent, reaching a low in 1951, 1957, and again in the late 1960's, increasing again in the 1970's, with the last three years' reaching the level it was in the very first year (1947) that the CPS series began. For families, there was a decline in inequality from the late 1940's to the late 1960's of the order of 7 to 8 percent, followed by an increase in the 1970's, which continued up through 1980, the latest year for which we have data, although the Gini ratio is still below the level reached in the late 1940's.

By its very nature, a single-valued measure of inequality cannot tell us what is happening in various parts of the size distribution. My second set of charts (Figures 2A and 2B) portray changes in the shares of various income groups in the distribution. The distribution is divided into five equal groups, or quintiles, based on a ranking of recipient units from lowest to highest, although I have divided the top quintile into two groups, the top 5 percent of recipients, and the 15 percentiles immediately below it (comprising the 81st through the 95th percentiles) to give a better view of that group. To give you some idea of where these groups fell in terms of 1980 money income, the mean income of the bottom quintile of consumer units was about $3,800; that of the next quintile, $9,600; the middle quintile, $16,300; the fourth quintile, $24,700; the 15 percentiles immediately above them, $37,500; and the top 5 percent, $67,630. The corresponding figures for families are $6,100 for the lowest quintile, $13,900 for the second, $21,000 for the middle quintile, $29,100 for the fourth, $42,000 for the next 15 percent, and $73,400 for the top 5 percent. The share of the bottom group shows a small rise over the 33 year period as a whole of about 10 to 20 percent, depending on the years selected, although most of that gain for the family distribution has been lost in recent years. On the other hand, shares of the second and middle quintiles have not fared as well. A decline in the second quintile's share is evident for both families and consumer units, particularly from the late 1960's on; for the middle quintile, the decline is much more apparent in the consumer unit than in the family distribution. Turning to the top of the distribution, the decline in the share of the top 5 percent over the period as a whole is clearly evident in the graph, although there has been some recovery in the past dozen years. On the other hand, there has been a noticeable rise in the past dozen years in the share of the group comprising the fifteen percentiles immediately below the top 5. To summarize, since the late 1960's the major redistribution in shares for consumer units has been from the second and middle quintiles to the top quintile of the distribution; for families, the major effect can be observed somewhat farther down the ranking--a redistribution, in effect, from the second quintile to the two groups comprising the 61st through 95th percentiles.

While comparisons of relative shares are perhaps the most useful way of summarizing changes in distribution, they do not tell us anything about the changes in real income enjoyed by these various groups. I have tried to capture these change for the family income distribution in Figure 3. This chart shows the mean real income (in dollars of 1967 purchasing power) of the various income groups over the entire postwar period. I have used a ratio scale for income, since it permits us to infer changes in relative shares as well as changes in the growth rate of real income. If, for example, the vertical distance between the lines for any two shares narrows, we can infer that the lower group has gained relative to one above it, e.g., the share of the bottom quintile in the graph relative to that of the second quintile. The well-known slowdown in the growth rate of the real family income since the late 1960's is quite evident. The graph also makes it clear that the real income growth virtually ceased for the bottom three quintiles, whereas growth for the three upper groups, particularly for the 81st through 95th percentiles, continued, although at a greatly reduced rate.

A similar picture is presented in my next chart, which shows (from 1959 on) the percent of all persons below the poverty line, as well as those below poverty living in families headed by females and by blacks. Again, the percentage in poverty declined up to the late 1960's and changed very little thereafter.

The distribution of income among demographic groups, e.g., by age, race, sex, educational attainment, has just as much interest as the distribution among groups defined by size of income. Lack of time has prevented me from showing more than one of these--that by age. Figure 5 portrays the median incomes of selected age groups (defined by the age of the head), expressed as a percent of median family income, for selected years over a twenty year period. (Nothing is said in this graph about the degree of inequality <u>within</u> each age group, although we know that inequality increases with age and that it is much greater within the 65 and older group than it is for any other.) The main conclusion that can be drawn from this graph is that the incomes of middle and older age groups have increased relative to those in younger age groups (below age 45) over the period as a whole.

Before trying to account for some of these trends, I want to indicate some of the qualifications that should be kept in mind in interpreting these data. First, membership in each quintile is determined by the ranking of recipient units by size of their incomes in each year. Thus, the membership in particular quintiles in terms of individual recipients changes from year to year, as some families experiencing substantial increases in their incomes from one year to the next shift from lower to higher quintiles, their places being taken by those whose incomes have not risen by as much or have actually fallen. The data on shifts in income distribution among quintiles should not be interpreted as applying to groups of unchanging membership.

Second, field survey data suffer from a number of deficiencies, particularly the non- and under-reporting of income. Income is understated by as much as 10 to 12 percent on the average in the CPS. Further, the effects of such underreporting are not spread evenly throughout the distribution, but concentrated in the two tails, particularly the upper one. A study we made for 1972 at the Bureau of Economic Analysis showed that the CPS mean family income of $12,635 would be increased to $14,019, or by 11.0 percent, if all money income in the national income and product accounts (NIPAs) were fully accounted for in the CPS income distribution. For the top 5 percent, on the other hand, the mean would have been increased from $39,900 to $51,300, or by 28.5 percent; for the top 1 percent of families, the mean would have gone from $65,000 to $92,200, an increase of 41.8 percent. This result is primarily due to the fact that property income is so poorly reported in the CPS, compared, say, to the reporting of wages and salaries or social security.

Third, the concept of total money income used in the CPS is not necessarily the most appropriate one for a number of purposes. For one thing, it excludes various kinds of nonmoney or imputed income, such as means-tested in-kind transfer programs--food stamps, medicaid, school lunch and rent subsidies--and entitlement programs such as medicare, although Census has begun to measure the recipiency, and occasionally the amounts, of such types. Other types of nonmoney income are the value of employee fringe benefits, such as employer contributions to employee life insurance and health and pension funds, and the noncash compensation of executives, such as stock options; food and lodging furnished free to employees, imputed rent on owner-occupied dwellings, and imputed interest (imputed income types included in BEA's family personal income but not in total money income); and capital gains (including ordinary income that can be converted to such gains under favorable treatment provided by the tax laws). While the direction of the change in inequality, if not the amount, for any given year is evident if in-kind transfer payments were to be included, the effect on inequality of including all in-kind income in the distribution, not just that accruing to lower income groups, is not at all clear. In the absence of a full study of the matter, it is difficult to determine whether on balance inequality would be increased or decreased. Our results for both the 1964 and 1972 BEA size distributions show that imputed rent and interest are more unequally distributed than is total money income.

In contrast to the inclusion of the entire income of unincorporated enterprises in Census's total money income, the latter includes only that portion of corporate profits which are paid out in dividends to shareholders. In a calculation I once made using the 1962 *Survey of Financial Characteristics of Consumers*, the share of the top 5 percent would have been raised by a minimum of 6 percent if all after-tax corporate income had been distributed to share holders, and by a total of 19 percent if all before-tax corporate income were imputed to shareholders (to place such income on the same footing as other income types in TMI, which are all on a before tax basis). The corresponding figures for the top 1 percent were 11 percent and 35 percent, respectively.

In addition to not knowing just how the inclusion of nonmoney income would affect the measurement of income shares for a given year, we are uncertain about the effects of such inclusions on the trend in inequality that I referred to earlier. The expansion of in-kind transfer programs in the last 10 to 15 years would certainly imply some rise in the share of the lowest quintile, since this group draws about 60 percent of its income from transfers, in contrast to the second quintile, for which the transfer share is less than 30 percent. On the other hand, employee fringe benefits have also expanded rapidly over the same period.

Another element omitted in CPS money income distribution is the effect of taxes. The CPS shows the distribution of before-tax, not after-tax incomes. Unfortunately, the estimation of accurate after-tax distributions is difficult and time-consuming, and we have little accurate information to go on. Indeed, I had been hoping that the Survey of Income and Program Participation, funding for which has been terminated, would provide the necessary data base for after-tax estimates. The studies I have seen suggest that the effect of all taxes--Federal, state and local--is, with the possible exception of two tails of distribution, roughly proportional, or at best mildly progressive, the results depending not only on the data base used, but on the particular assumptions made about the shifting and incidence of various taxes. (See, e.g., Pechman and Okner, Who Bears the Tax Burden? ch. 1.) Since, as noted above, only the corporate income tax is in effect excluded from TMI, I would guess that the CPS before-tax distributions are not bad estimates of after-tax distributions, although the latter might show some small reduction in the Gini ratio if they were available.

I think it is evident from my remarks so far that there is a substantial amount we do not know about income distribution--both in levels and trends. This observation is even truer for the distribution of wealth. Only more and better data will permit economists and analysts to improve their answers on trends in income distribution, the reasons for those trends, and the effects of various policies, such as changes in taxes, transfers, whether cash or in-kind, interest rates, and shifts in government expenditure. Yet the Reagan administrations seems to be headed in precisely the opposite direction, as if it had no interest in preserving the data base that has been so painstakingly been built up over many years, much less in considering needed improvements. BEA has already phased out its work on aggregate estimates of nonmoney income and is in the process of phasing out all its work on the size distribution of family personal income. Census is currently undergoing budget cuts and reductions-in-force that make one concerned about just what programs in the income distribution area will survive, much less what will be their quality. But one of the biggest losses will be in the Income Survey Development Program (ISDP), previously sponsored and funded jointly by Census and by SSA and the Office of the Assistant Secretary for Planning and Development (ASPE) in HHS. Despite a five year development program which would have led to a continuing, ongoing survey emphasizing the collection of data on income, wealth, and participation in Federal and state programs, and incorporating many improvements in data collection methods, funds for instituting the Survey of Income and Program Participation were eliminated last summer. Now it appears that funds and personnel needed to complete the processing of the experimental ISDP panel survey for 1979 are also being eliminated; there is now a real danger of that government and private analysts will be prevented from getting access to the data, making it impossible for any one to complete the data processing necessary to create a public use file should the executive branch be unwilling to do it. In view of the millions of dollars that have been spent on this program in past years, and the interest and support of various government agencies (both in the executive and legislative branch) as well as private research workers outside the Federal government, I do not see how scrapping this work and failing to release the resulting microdata files to the public domain can be justified. One wonders if this administration fears what the data may show. Is it true, to paraphrase some common sayings that they believe that "no data are good data" and "what they don't know can't hurt them"? In contrast to all previous administrations, the leaders in this one appear to believe that economic policy can be made and carried out in the dark.

It is a more difficult job to account for the trends in income distribution that I have noted. One cannot appeal to changes in tax rates and laws, since, as I have already noted, the CPS distributions are before tax. One important cause may be the increase in unemployment since the late sixties. Whether by using time series regression analysis or simulation studies, most investigators have found a significant direct relationship between changes in inequality and changes in the unemployment rate. One can even see a moderately clear relationship in the series shown in Figure 1. To cite one study, Jean Salter and I found, after controlling for changes in income types and the inflation rate, that the Gini concentration ratio for families was increased by a third of a percentage point for each one percentage point increase in the unemployment rate. Regressions run on the quantile shares used in my charts imply a fall in the shares of the two lowest quintiles and a rise in shares for those income groups above them, given a rise in the unemployment rate. On the other hand, we found no significant relation to the inflation rate, as measured by the annual rate of change of the implicit price deflator for GNP. While simulation studies, such as the one David Seiders and I did some years ago, have shown some redistributive effects of unanticipated inflation, with the bottom two quintiles and the top 5 percent losing to the middle groups, the effects were very small--less than a one or two percent change in share for a change in the inflation rate of 5 percentage points. This is not to deny that inflation may shift individual consumer units about in the distribution, as some gain and others lose--only that there is no systematic bias of inflation that shows up in overall measures of inquality.

One hypothesis relates longer term changes in the demographic composition of consumer units to changes in inequality. One of the most important of these changes is the rise in the proportion of unrelated individuals (UIs) to consumer units (CUs). While the percentage of UIs to total CUs was rising slowly in the earlier postwar period, the percentage has grown rapidly in the past 14 years, increasing from 20 percent in 1966 to 31 percent in 1980. This change is of considerable importance, since the mean income of UIs is only about 45 percent of that of families, and the inequality in the UI distribution is greater than that in the family distribution. (For example, in 1980 the Gini ratio for families was 36.5 percent; for UIs, 43.5 percent.) This fact alone goes a long way to reconciling the divergent trends in the distribution of income by consumer units and by families.

A similar factor has been operating within the family distribution. The percentage of families headed by females (no spouse present) to all families was relatively stable until the mid-sixties, at about 10 percent. It then began to rise, until in 1980 such families were 15 percent of the total. Since the income of female-headed families again averages only about 45 percent of male-headed families, the disequalizing effect of this demographic shift is readily apparent. On the other hand, with respect to another important demographic trend, the rising proportion of working wives, a recent study by Douglas Wion shows that this increase has had only minor effects on inequality in the distribution of the earnings of married-couple families.

A final possible source of the observed changes in inequality is changes in the distribution of total money income by income types. The income type distribution is important because of differences in the importance of income types at various income levels. For example, for BEA's fully estimated total money income in 1972, the bottom quintile received 37 percent of its income in wages and 59 percent in transfer payments; for the second quintile, the percentages are 61 and 26 respectively. The groups comprising the 41st through 95 percentiles, on the other hand, received most of their income (approximately 80 percent) in wages, with self-employment income making up another 6 percent. While a little over half of the income of the top 5 percent was from wages, self-employment income accounted for 24 percent and property income another 21 percent of the income they received. It is easy to see, for example, that an increase in wages relative to other income types will favor the middle and upper income groups, whereas a rise in self-employment and property income will tend to increase the share of the top 5 percent.

The shares of income types in total money income are shown in Figure 6. On balance, over the postwar period as a whole, the share of wages has risen, that of self-employment income (both farm and nonfarm) has fallen drastically, and the share of property income has increased modestly, with the significant rise in the share of interest income's being largely offset by the relative decline in other types of property income (dividends, rents, royalties, and estate and trust income). The share of transfer payments has grown substantially, although the primary growth has been in the form of pensions and social security benefits; other transfers have on balance declined as a percent of TMI over the entire period. The effect of these changes should have been equalizing, at least up to about 1970; after that date the fall in the wage share, the small rise in the share of property income, and a tapering off in the rise in the transfer shares after 1975, are all consistent with the observed increase in inequality in the past 10 years.

I have little time left to consider the effect of President Reagan's programs on the distribution of income. While it would take some time and effort to try to nail down the quantitative impact of budget cuts in social programs, increases in defense spending, and recent and scheduled reductions in taxes, it is clear that nearly all bear in the direction of increased inequality. This is virtually self-evident with respect to budget reductions in welfare and social programs. The supply-side considerations that appear to have motivated the tax reduction led to placing of little weight on distributional considerations; in any case, a percentage reduction in tax rates, coupled with a reduction in the maximum tax rate on property income, from 70 to 50 percent, is bound to increase after-tax income inequality, although it will have little effect on the kinds of before tax distributional statistics I have used in this statement. The distributional impact of the projected increase in defense spending is more difficult to judge. Insofar as goods and services purchased by the military are more capital intensive and require a higher proportion of professional services and skilled labor than elsewhere in the economy, it is possible that rates of remuneration for the productive services, which may well be owned by consumer units in the upper part of the distribution, will be bid up. However, I am not clear about the empirical basis for the possible scenario I have sketched out.

The proposal to turn back a number of social programs to the states will have effects which are hard to predict at this time. Certainly, the disparity by states in support levels for various programs will increase; one might suspect as a result an increase in inequality among the poor themselves, with an increase in the size of the poverty income gap, if not in the number of poor. If the reduction in Federal spending for these decentralized programs is not fully offset by a rise in state and local spending, there is a further reason for supposing the share of the bottom qunitile will decline, although it would be impossible to give a quantitative estimate at this time.

It is not clear who we are supposed to "blame" for the current recession or depression--the President, Congress, or Paul Volcker. In any case, whoever or whatever its cause, we know that the current high level of unemployment and probable further increases in that level will tend to result in more inequality. High interest rates have their main effect on distribution through their effect on output and employment; their direct effects are harder to judge, although it is possible that the balance of considerations would point to somewhat more inequality.

Policies must not, of course be judged solely on their distributional effects. Efficiency and growth are also important considerations. Even judged by these latter standards, however, some of the President's proposals are hard to understand. Is it efficient to make only minor cuts in agricultural price support programs, or leave spending by the Corp of Army Engineers for water and navigation projects largely unchanged? Is it conducive to long-term economic growth--equity aside--to reduce drastically the support for college students, both graduate student and undergraduates, in the form of loans and aid? After going to great lengths in its tax reform act to encourage investment in physical capital through such policies as liberalized depreciation schedules, it proposes cuts that may substantially reduce investment in human capital. Where is the evidence that the return on the former is so much greater than that on the latter, that we are justified in going out of our way to subsidize the former, but reduce significantly the financing and subsidization of the latter? Another anomoly, although it has been with us through the entire history of income tax laws, is that only depreciation and depletion on physical capital and selected natural resources can be deducted in determining net taxable income from such resources; labor income, on the other hand, has always been taxed gross of the corresponding depreciation of human capital.

On balance, it may be better to rethink recently adopted administration policies, or closely scrutinize proposed ones, for their effects on equity and efficiency, than to think up new ones that stand little chance of adoption in any case. What about rethinking last summer's tax package? Was too much in the way of increased benefits to special interest groups incorporated in the act just to get it passed? One not so amusing side effect of this act, in terms of the quality of our tax statistics for making size distribution estimates, is its effect on the reporting of property income on individual tax returns. While some have argued there is not that much there now (arguments that I am skeptical of), the new law will make this situation far worse; IRS IRA's and all-savers' certificates are two examples.

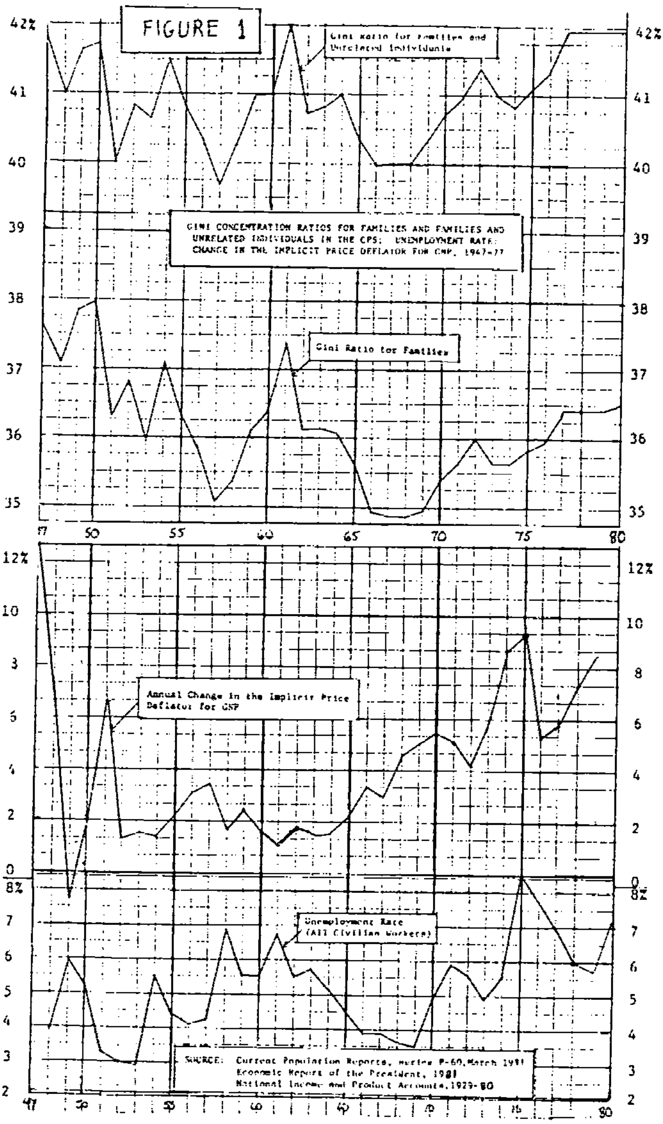


FIGURE 1
GINI CONCENTRATION RATIOS FOR FAMILIES AND FAMILIES AND UNRELATED INDIVIDUALS IN THE CPS; UNEMPLOYMENT RATE; CHANGE IN THE IMPLICIT PRICE DEFLATOR FOR GNP, 1947-77
Gini Ratio for Families
Annual Change in the Implicit Price Deflator for GNP
Unemployment Rate (All Civilian Workers)
SOURCE: Current Population Reports, series P-60, March 1981
Economic Report of the President, 1981
National Income and Product Accounts, 1929-80
42%
41
40
39
38
37
36
35
12%
10
8
6
4
2
0
8%
7
5
3
50
55
60
65
70
75
80

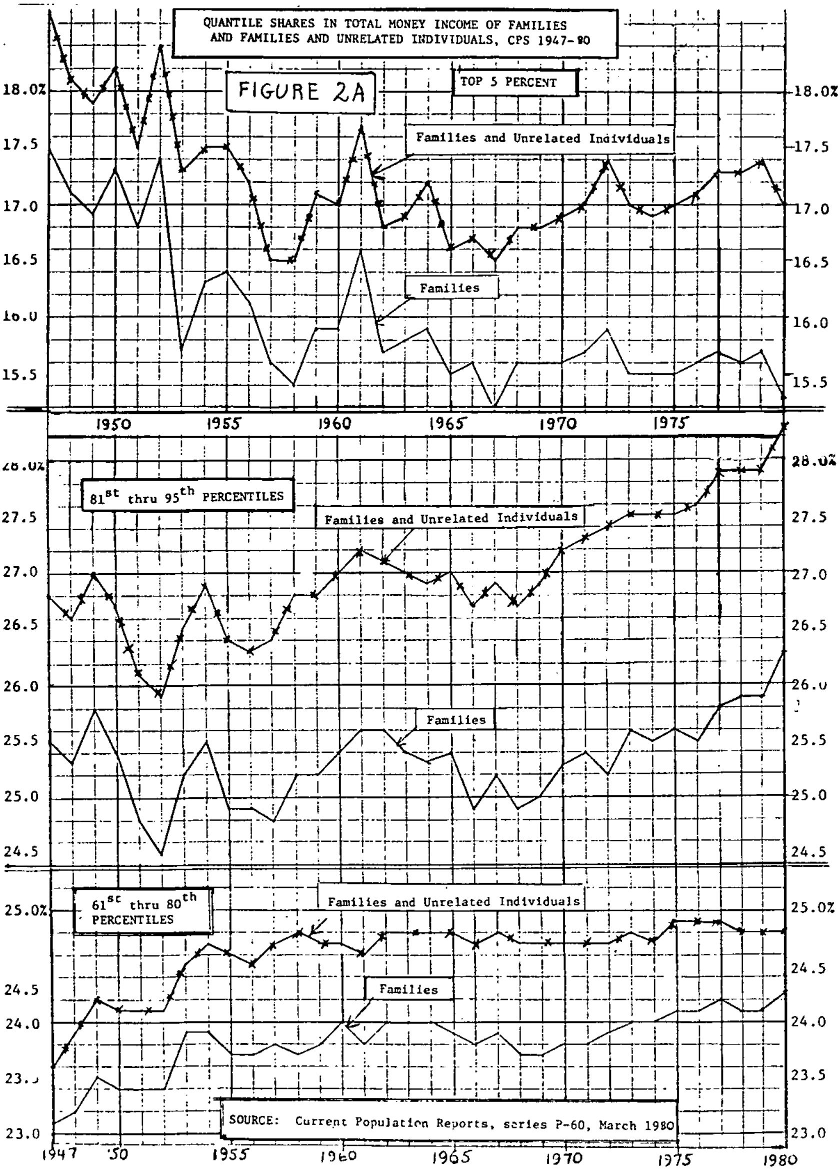
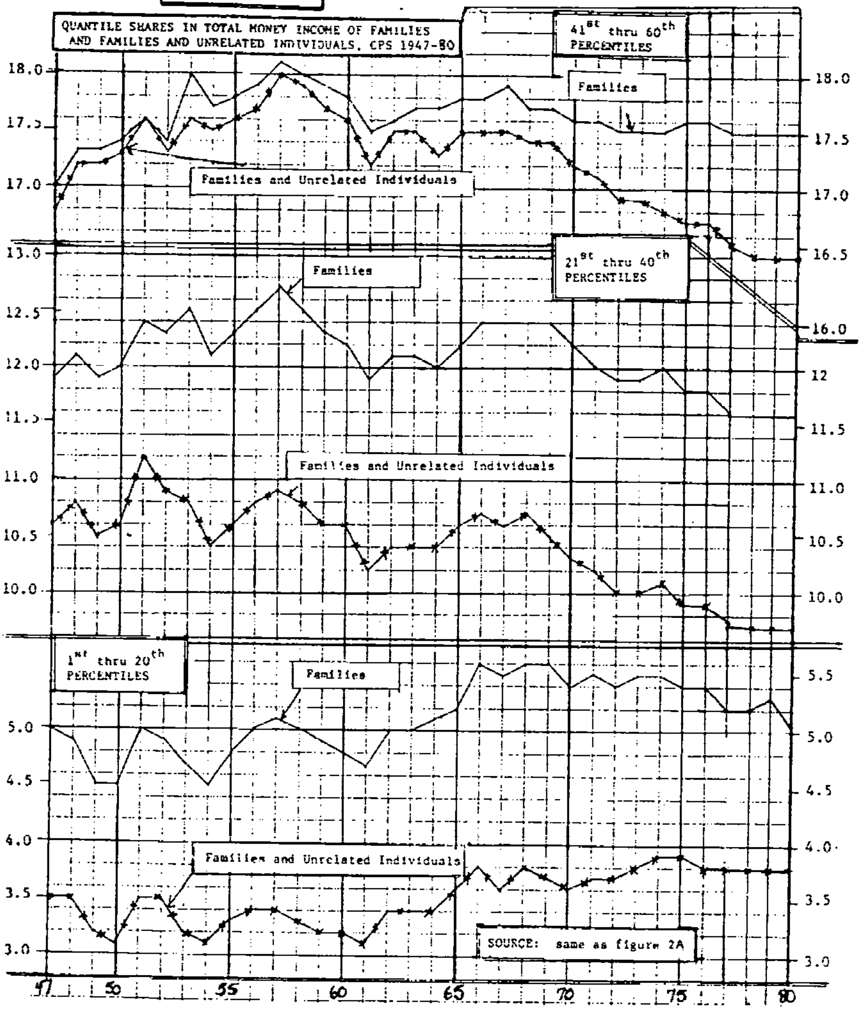

QUANTILE SHARES IN TOTAL MONEY INCOME OF FAMILIES AND FAMILIES AND UNRELATED INDIVIDUALS, CPS 1947-80
FIGURE 2A
TOP 5 PERCENT
Families and Unrelated Individuals
Families
81st thru 95th PERCENTILES
Families and Unrelated Individuals
Families
61st thru 80th PERCENTILES
Families and Unrelated Individuals
Families
SOURCE: Current Population Reports, series P-60, March 1980
18.0%
17.5
17.0
16.5
16.0
15.5
28.0%
27.5
27.0
26.5
26.0
25.5
25.0
24.5
25.0%
24.5
24.0
23.5
23.0
1947
'50
1955
1960
1965
1970
1975
1980

FIGURE 2B


QUANTILE SHARES IN TOTAL MONEY INCOME OF FAMILIES AND FAMILIES AND UNRELATED INDIVIDUALS, CPS 1947-80
41st thru 60th PERCENTILES
Families
Families and Unrelated Individuals
21st thru 40th PERCENTILES
Families
Families and Unrelated Individuals
1st thru 20th PERCENTILES
Families
Families and Unrelated Individuals
SOURCE: same as figure 2A
18.0
17.5
17.0
16.5
16.0
13.0
12.5
12.0
11.5
11.0
10.5
10.0
5.5
5.0
4.5
4.0
3.5
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47
50
55
60
65
70
75
80

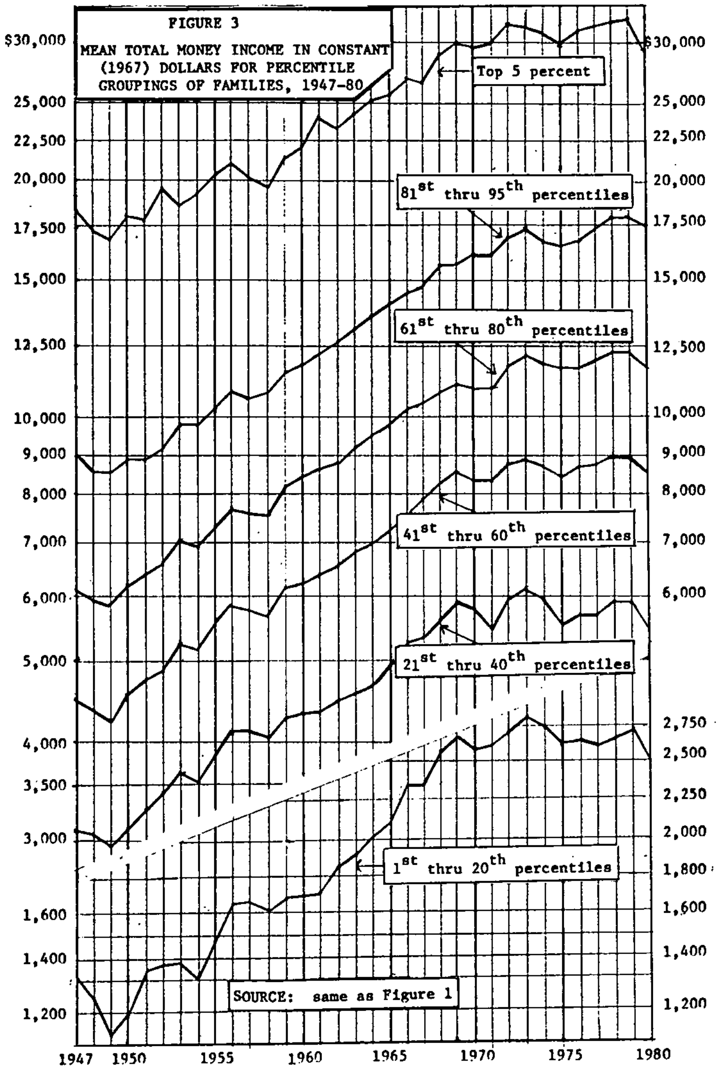
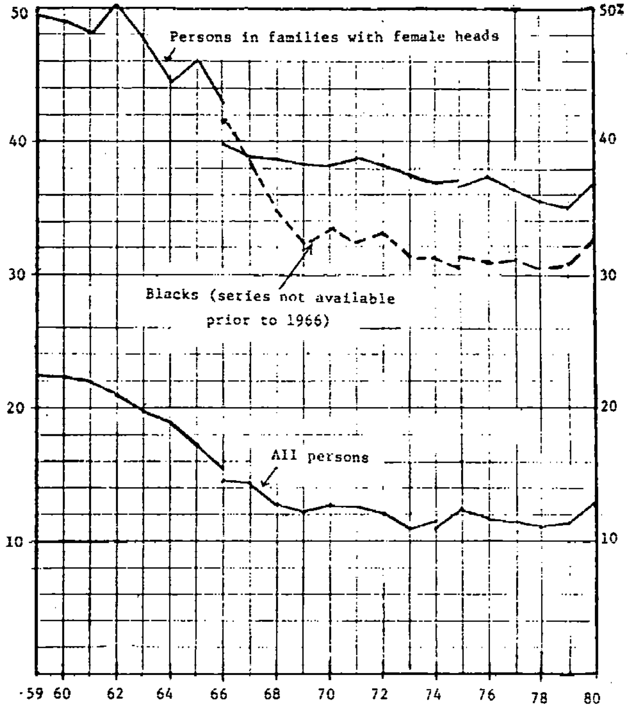


FIGURE 3
MEAN TOTAL MONEY INCOME IN CONSTANT (1967) DOLLARS FOR PERCENTILE GROUPINGS OF FAMILIES, 1947-80
Top 5 percent
81st thru 95th percentiles
61st thru 80th percentiles
41st thru 60th percentiles
21st thru 40th percentiles
1st thru 20th percentiles
SOURCE: same as Figure 1
$30,000
25,000
22,500
20,000
17,500
15,000
12,500
10,000
9,000
8,000
7,000
6,000
5,000
4,000
3,500
3,000
1,600
1,400
1,200
2,750
2,500
2,250
2,000
1,800
1947
1950
1955
1960
1965
1970
1975
1980

FIGURE 4

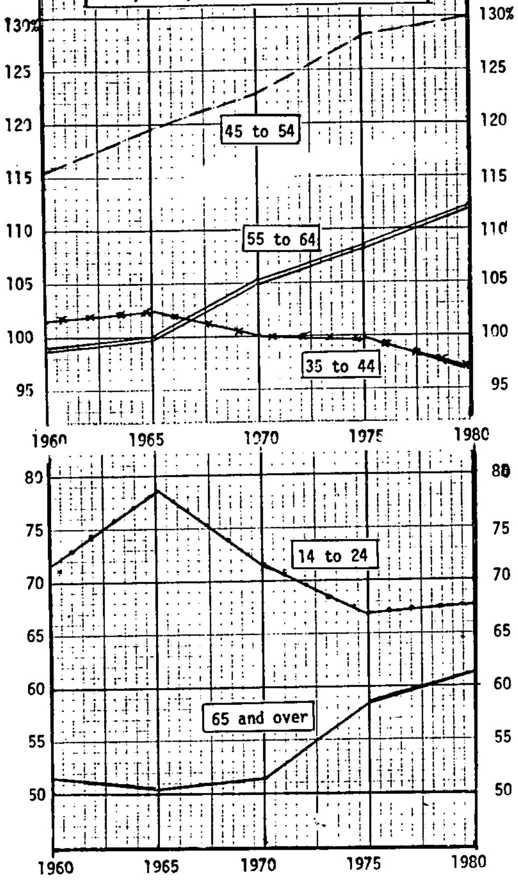
PERCENT OF PERSONS BELOW POVERT LINE



Source: Bureau of Census, Current Population Reports, Series P-60, no. 127, Persons in poverty based on the poverty status of the family.

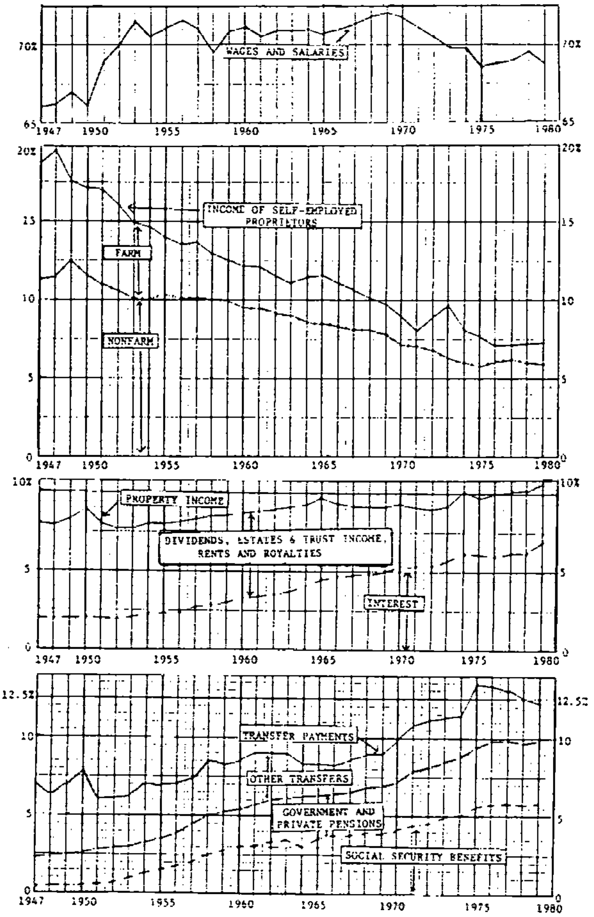
FIGURE 5

MEDIAN TOTAL MONEY INCOME OF SELECTED AGE GROUPS AS A PERCENT OF THE MEDIAN TOTAL MONEY INCOME FOR ALL FAMILIES, 1960, 1965, 1970, 1975, and 1980.



Source: Current Population Reports, Series P-60, various issues

FIGURE 6
SHARES OF INCOME TYPES IN TOTAL MONEY
INCOME (Census Concept) 1947-1980



Source: Bureau of Economics Analysis, U.S. Department of Commerce.

*Includes public assistance, unemployment and workmen's compensation, veterans' benefits and other public and private transfers.

[From the Washington Post, Feb. 6, 1982]

KILLING THE BEARER OF BAD TIDINGS

(By Ellen Goodman)

BOSTON.—Sooner or later they were bound to solve this whodunit. The Reagan people were determined to burrow down and root out the cause of all these expensive social problems.

Finally, they have come up with their favorite candidate for the ultimate American Troublemaker title; Data. The Data did it, and now Reagan is doing it to the Data.

The latest agency in Washington to be "riffed" by the grim Reagan reaper is the primary data-gatherer, the Bureau of the Census.

In the case of the Census Bureau, RIF, "reduction in force," means a cutback in employees—about 500 will be laid off and 5,400 given partial furloughs. But is also and inevitably means a cutback in information. This is what makes the riffing of the Census Bureau a case study of how Reagan is unraveling social programs.

The Bureau of the Census is the major outfit in Washington assigned to tell us something about ourselves. It's a collector, sorter and keeper of statistics. It tallies up our age, sex, race, income, employment and other geographic, social and economic facts.

Census is, in short, our public research bureau. And the Reagan administration is not feeling warmly toward the researchers, public or private, in the federal bureaucracy or academia. After all, they have long been in the business of gathering up the mischievous numbers.

During the era of creating federal programs, researchers were busy uncovering problems. The safety net was woven in large part out of their data.

The 1950s way of expanding government programs went somewhat further, but the process was similar. First, a group of people in academia or politics or the media would "discover" a social issue—hunger for example. Then the researchers would go out and collect the numbers.

Once the figures were in, we knew how many people were hungry and where they were hungry. We has a certifiable problem. We held hearings, we called for solutions, we passed legislation and started distributing things like food stamps.

Now we have an administration that wants to turn this process around, to contract federal programs, or scatter them to the 50 state winds. You can't unravel it without unraveling the research. So it isn't a coincidence that the money to identify social problems has shrunk along with the money to study them and the money to alleviate them.

Meanwhile, if one agency is cutting food, shelter and medical care, the last thing the administration wants is to see another agency tallying up the pain. If one agency is cutting programs, they don't want another spewing out numbers that prove the programs are necessary. The are better off letting sleeping statistics lie.

The end result is that funding social research in this administration is as popular as leaking defense secrets. What we don't know can't hurt them.

The Bureau of the Census isn't going to fold up shop. Its basic functions are protected by the Constitution. But the bureau and the other agencies may be severely limited in gathering and sharing information. As for the academics who depend on federal grants, their studies of society has been crippled. But the rampant riffing of researchers adds an elegant simplicity to the whole Reagan plan. You may not be able to cure unemployment, but by golly, you can stop counting it. You may not be willing to help the poor, but you can stop offering up the proof of their poverty. You may not be willing to help the displaced homemaker, the abused child, the undernourished, but you can make them invisible again.

Who knows, without all that data around to keep bothering us, poverty, unemployment, even hunger, will just disappear. This is the way they solve problems in the New Reagan Era: they kill the Data.

Representative REUSS. Thank you very much, Mr. Budd.

Mr. Danziger.

STATEMENT OF SHELDON DANZIGER, RESEARCH ECONOMIST, INSTITUTE FOR RESEARCH ON POVERTY, AND ASSOCIATE PROFESSOR OF SOCIAL WORK, UNIVERSITY OF WISCONSIN-MADISON

Mr. DANZIGER. Thank you, Congressman Reuss. To avoid overlap with Professor Budd and some of the other discussants, I will summarize my prepared statement and then emphasize the effect of the current administration's program on the poor, which is the last part of my prepared statement.

After review of the evidence on the trend in inequality and analysis of the effect of several important demographic and economic factors, which is shown in the first seven tables of my statement, I derive the following conclusions:

TRENDS IN INCOME DISTRIBUTION

One, the degree of inequality was relatively constant over the 1950 to 1980 period; but it has been increasing at a slow and steady rate for the past 15 years.

Two, demographic change has accounted for some of the increase in inequality. However, because labor market forces contributed to an increase in pretransfer inequality, inequality would not have increased, even if there had been no demographic change.

Three, Government transfer programs dramatically reduce inequality for several population subgroups and have a significant impact on the aggregate degree of inequality. If Government transfers had not been growing, the increase in inequality would have been substantially larger.

Four, the contribution of working wives to family incomes has reduced inequality while fringe benefits have increased inequality, but the effects of both of these are smaller than those of Government transfers.

TRENDS IN POVERTY

Because some have argued that Government policies should not be addressed to the income distribution per se, the trend in poverty is then examined. Again, I derive these conclusions: first, that the growth of income transfers, not labor market improvements, has been the primary factor in the reduction of poverty in the past 15 years.

Two, poverty remains at high levels for many subgroups among the population, especially female-headed households with children.

Three, income transfer programs do create disincentives to work and save, but their magnitude has been relatively small, and they pose no threat to the overall efficiency of the economy.

EFFECT OF REAGAN PROGRAMS

Then, some projection of the effects of the Reagan administration's economic programs are offered. The conclusions in this area are: first, reductions in taxes for those toward the top of the income distribution and decreases in transfers and other social welfare programs for those toward the bottom will increase poverty and income inequality.

Because of their reliance on income transfers, employment and training programs and regular public sector jobs, female-headed families, minorities, and those in the second income quintile who become unemployed are likely to experience the largest losses from the administration's program.

The incidence of poverty as officially measured is likely to return to the levels that existed in the late 1960's shortly after the war on poverty was declared.

Finally, even if the economy recovers, the gains that trickle down to those at the bottom of the distribution are not likely to be large enough to offset the direct losses from the budget cuts.

FURTHER DISCUSSION OF POVERTY DATA

I would like to now turn from that summary to the part of the prepared statement that deals with poverty. As I say, the summary measures of inequality in my statement and in Professor Budd's statement are affected by changes in either the incomes of the poor or the nonpoor. It has often been argued that Government policy should not be addressed to income distribution per se. For example, Robert Tolson and Kevin Hopkins, two administration representatives, recently wrote in an issue of "Public Welfare" the following quote:

> Inequality of incomes in itself becomes something to be corrected only to the extent that the poorest do not have sufficient resources to provide for their needs.

So, to reflect this concern evidenced by the administration spokesmen with those at the bottom of the distribution, I would like to look in some greater detail at the trends in poverty. The trends in poverty mirror the trends in inequality in the sense that we had a decline in the late 1960's, but an increase recently.

GOVERNMENT PROGRAMS HAVE REDUCED POVERTY

It's important to point out the official Census measure that includes only cash transfer shows a decline of 17 percent, while the adjusted income measure—based primarily on the work of Timothy Smeeding at the University of Utah and as a consultant to the Census Bureau—which accounts for in-kind transfers and Federal transfers, shows a decline of almost 50 percent in poverty. So there have been important reductions in poverty, but they are due primarily to the increases in Government cash and in-kind benefits.

Nonetheless, despite the growth in transfers, the official incidences of poverty in 1978 among children living in female-headed households was 31 percent for whites, 58 percent for blacks, and 61 percent for Hispanics. These high incidences and the recent upward trend in the percentage of children living in female-headed families refutes the view that poverty had been virtually eliminated.

As part of my prepared statement, I submit another paper "Children in Poverty: The Truly Needy Who Fall Through the Safety Net," which I would like entered into the record, which provides a lot of data on this particular group among the poor.

Representative REUSS. Without objection, it will be received.

Mr. DANZIGER. Between 1965 and 1978, welfare recipiency did increase in this group from about 26 percent of female heads of families to 38 percent, but the percentage of female heads who worked remained constant at about 65 percent working at some point in the year.

Thus, despite increased welfare recipiency and the maintenance of work effort, poverty among female heads remains a serious problem.

Table 9 in my statement presents data on the dependence on cash transfers of all households and of pretransfer poor households, classified by the age, sex, and race of the head. It's important to note how large a percentage of households depend on income transfers. While almost all of the aged poor received transfers, however, almost 40 percent of nonaged poor households received none. And this is data from 1978 before the current cuts in transfer programs. And the probability of receiving enough aid to escape poverty is much lower for the nonaged than the aged.

The recent growth of income transfer programs has had important beneficial effects—protection against income losses due to unemployment, retirement, disability, and death; guarantees of access to minimum levels of food, shelter, and medical care; and the reduction of poverty and inequality. This growth has been accompanied by some declines in work effort and savings that have contributed to sluggish economic performance. But the magnitude of these disincentives has been overstated.

A review of the available research published in the Journal of Economic Literature in September by myself and several colleagues at the Poverty Institute suggested the decline in aggregate work effort due to income transfers is less than 5 percent. The effect on savings is quite speculative, depending on which author one casts with, and it ranges from zero to 20 percent.

Nonetheless, these disincentives pose no serious threat to the growth of the economy, and they could be reduced by reforming, not eliminating, the transfer programs. The elimination of these programs will lead to small gains in efficiency but large increases in poverty and inequality.

REAGAN PROGRAM WILL INCREASE INEQUALITY * * *

The Reagan administration's drastic fiscal retrenchment to reduce Government presence in the economy was claimed to be evenhanded; yet it is clear that the new priorities reflect dissatisfaction with the growth of social welfare expenditures over the past 15 years. The program claims to maintain the safety net so as to insure the well-being of the truly needy.

However, the short-run direct effect of the administration's programs are clear. The tax changes will increase the disposable income of those toward the top of the income distribution; and the budget changes, especially those in the income transfer programs, will lower the incomes of those toward the bottom. As a result, both poverty and income inequality will increase.

* * * AND WILL CUT WORK INCENTIVES FOR THE POOR

Consider the effects of the budget cuts on one of the poorest groups I mentioned, female heads of household with children. They will be disproportionately affected. Many relied on CETA jobs. Others working in the private sector have either lost eligibility for AFDC, which probably results in a loss of medicaid benefits or have had their benefits significantly reduced by the new rules on work expenses and allowable assets.

In your State and mine, Congressman, consider the fiscal 1982 changes on a typical working welfare mother with one child in Wisconsin. She earned $432 per month, reported average work expenses of $108, and received $217 from AFDC. As a result, her monthly disposable income was $140 higher than that of a nonworking AFDC mother with one child who received $401 per month. Starting February 1, after 4 months of welfare recipiency, her earnings reduce her welfare benefits even further, and she receives only $44 from AFDC. Her income after work expenses is now actually $33 per month lower than that of the nonworking woman, representing a 32-percent cut in her cash income.

Given cases like this, it should come at no surprise that program administrators expect some of these women to quit working. If the woman in this example does quit, AFDC costs would not fall from $217 to $44, but would rise to $401.

At the same time as the proposed income tax reductions are cutting tax rates for the rest of the population, welfare beneficiaries who already face high benefit reduction rates are experiencing even higher rates and work disincentives. If the lowered income tax rates lead the nonpoor to work more, as is hoped, and the higher rates lead welfare recipients to work less, as my example suggests, the gap between the income classes will increase even more.

In addition to welfare women, many low-income, two-parent working families in the second quintile of the distribution will suffer large income losses. Households in this group have experienced the greatest reduction in their income share over the recent past, partly because their incomes are too high to qualify for Government transfers and because their jobs are more cyclically sensitive and offer lower fringe benefits than those in the higher quintiles.

This decline in the share of the second quintile means—as you know, since one of the papers I cite is that piece you published in Challenge magazine recently—that the second quintile is now bearing the brunt of the increased unemployment rate in the private sector and the reduction in employment and training programs.

According to estimates by Lester Thurow, employment and training programs accounted for 14 percent of the earnings received by the bottom two quintiles of the labor force. These households now find that the extent of protection against income loss provided by food stamps and extended unemployment compensation in recent recessions has been reduced

BLACKS WILL BE HURT WORST

Minorities will also be disproportionately affected by the budget cuts. A recent estimate shows that 27 percent of all blacks, as compared to 16 percent of all whites, worked in the public sector. About 55 percent of the net employment increase for blacks since 1960 occurred in the public sector, and most of this was in social welfare programs. Thus, reductions in Government employment in general, and social welfare employment in the public sector in particular, will affect blacks more than whites.

WILL "SUPPLY-SIDE" GROWTH HELP? NOT ENOUGH

But, what of the supply-side miracle? Suppose that the administration's program does succeed in stimulating economic growth. As suggested above, the major factor contributing to the reductions in poverty and offsetting increases in inequality was the growth in Government transfer payments.

Peter Gottschalk has examined the evidence concerning the trickle-down hypothesis in two public papers, which I cite, and I'd also like to submit for the record something I just gave to your staff this morning, a short piece entitled "Have We Already Lost the 'War on Poverty?'" in which Professor Gottschalk provides some projections of poverty that I will discuss now.

Representative RUESS. Without objection, that will be received.

Mr. DANZIGER. Gottschalk concludes that there is little reason to think that the earnings gains from economic growth that accrue to those with labor market disadvantages are likely to be large enough to significantly reduce poverty. Unless policies are implemented to alter the structure of the labor market facing the poor, then poverty would decline little in the 1980's even if unemployment remained at 6 percent and cash transfers grew as fast as national income.

Gottschalk provides an estimate in the piece that's been entered into the record that poverty in 1980 will be 13.7 percent; whereas, the official rate for 1980 is 13 percent.

I would like to point out that the budget cuts just went into effect in October 1981, and so the effect on the poor is likely to be larger than that indicated in Gottschalk's estimate for 1981. As a result, I've made a few calculations based on the model in this paper.

Assuming an unemployment rate of 8½ percent for 1982 and assuming a decline in real transfers of 5 percent, which would be a drop of about $13 billion in cash transfers for 1982, poverty in 1982 I would project to be 15.34 percent, as officially measured. That's a rate which has not been recorded officially since 1966.

Obviously, as I mentioned earlier, the effect of inkind transfers, which are not measured, does suggest that poverty is lower than it was in 1966. But the cuts in cash and inkind transfers will nonetheless increase poverty in this case by at least 1½ percent.

I then use Gottschalk's estimates to say what if the supply-side miracle works. Suppose we do have a decline in unemployment to 5½ percent by 1984. That I believe would be a vindication of the supply-side miracle.

So I assumed in this calculation that unemployment does fall to 5½ percent by 1984, but I also assumed that one of the costs of getting to 5½ percent unemployment is that real transfers will drop by 15 percent in real terms. That would be about a $45 to $50 billion decline in income transfers, which again is the kind of magnitude that the administration is projecting.

Unfortunately, the decline in real transfers has a propoverty effect which almost entirely offsets the antipoverty effect of the decline in unemployment; so that my estimate for 1984, even if the supply-side miracle does take place, would be a poverty rate of 13.5 percent, which would be only a significant—very insignificant decline from Gottschalk's estimates for 1981.

In conclusion, I would like to suggest that the information which has been disseminated by the administration as to the problems of income transfer programs has been to much extent not derived carefully from the literature. I would argue that there have been exaggerations about the degree to which poverty has been reduced, that we find no evidence that poverty has been eliminated, particularly for some of the groups that I've mentioned, that the extent of the work disincentives and savings disincentives of transfer programs, again, has been overstated. The extent to which it has been claimed that benefits will trickle down to the poor has been overstated. The extent to which the private sector is likely to fill gaps has been overstated, and the extent to which Government programs can easily distinguish work from welfare has been overstated.

The research evidence cited in my prepared statement suggests that there is some truth to each of these claims, but that the positive effects of income transfer programs are much larger than has been admitted and the negative effects are much smaller.

In sum, even if the administration's program generates a recovery, the gains that trickle down to those at the bottom of the income distribution are not likely to be large enough to offset the direct losses from the reduced transfer and other social programs.

[The prepared statement of Mr. Danziger, together with the attachments referred to, follows:]

Prepared Statement of Sheldon Danziger[1]

INTRODUCTION AND SUMMARY

The size distribution of household income has remained stable over the past thirty years, despite significant changes in various economic and demographic factors--fluctuations in economic growth, increases in government transfer payments, increases in female labor force participation and the changing age and household composition of the population. This testimony reviews the evidence on the trends in income inequality and poverty and offers some projections as to how the fiscal year 1982 budget cuts and those now being proposed for fiscal year 1983 might affect the income distribution.

After a review of the evidence on the trend in inequality and an analysis of the effect of several important demographic and economic factors, the following conclusions are derived.

- The degree of inequality was relatively constant over the 1950-1980 period, but it has been increasing steadily for the past fifteen years.
- Demographic change has accounted for some of the increase in inequality. However, because labor market forces contributed to an increase in pretransfer inequality, inequality would not have decreased, even if there had been no demographic change.
- Government transfers dramatically reduce inequality for several population subgroups and have a significant impact on the aggregate degree of inequality. If transfers had not been growing, the increase in inequality would have been substantially larger.
- The contribution of working wives to family incomes has reduced inequality while fringe benefits have increased inequality, but these effects are smaller than those of transfers.

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[1] The author acknowledges the support of the Graduate School Research Committee of the University of Wisconsin-Madison and the computational assistance of Daniel Feaster.

Because some have argued that government policies should not be addressed to the income distribution _per se_, the trend in poverty is then examined. It is shown that:

- The growth of income transfers, not labor market improvements, has been the primary factor in the reduction of poverty in the past fifteen years.
- Poverty remains at high levels for many subgroups among the population, especially female-headed families with children.
- Income transfer programs create disincentives to work and save, but their magnitude has been relatively small and poses no threat to the overall efficiency of the economy.

Then, some projections of the effects of the Reagan Administration's economic programs are offered.

- Reduction in taxes for those toward the top of the income distribution and decreases in transfers and other social welfare programs for those toward the bottom will increase income inequality.
- Because of their reliance on income transfers, employment and training programs and regular public sector jobs, female-headed families, minorities, and those in the second income quintile who become unemployed are likely to experience the largest losses from the Administration's program.
- The incidence of poverty as officially measured is likely to return to the levels that existed in the late 1960s, shortly after the War on Poverty was declared.
- Even if the economy recovers, the gains that trickle down to those at the bottom of the income distribution are not likely to be large enough to offset the direct losses from the budget cuts.

3

THE PERSISTENCE OF INEQUALITY

Table 1 presents the familiar Census data on two summary measures of inequality, the Gini coefficient[1] and the income shares received by each quintile. Data for households-families and unrelated individuals--are presented in Panel A and for families only in Panel B. While the data for any two years are quite similar, several trends are apparent. First, the income share of the lowest quintile increased over the 1950-79 period, while the share of the second quintile declined. As emphasized below, the gains made by this bottom quintile result primarily from the increase in government income transfers. Second, while the trends are not very large, overall inequality declined from 1950 to about 1966 and then began to increase.[2] Again, as emphasized below, this trend towards increased inequality is likely to persist.

The Census data reported in Table 1 do not include government or private fringe benefits in kind such as Medicare, food stamps, housing assistance, or employer-provided pensions and health insurance.[3] These non-cash items have increased rapidly as a percentage of total income in recent years. While no study of inequality has incorporated the effects of both in-kind transfers and fringe benefits, existing studies do suggest that they have opposing effects.

Several studies have found that in-kind transfers reduce inequality. They have a significant impact on the income share of the lowest quintile of households, and smaller impacts on the share of the other quintiles.[4] For example, G. William Hoagland estimates that the quintile shares after all transfers (cash as well as in-kind), and after federal taxes, were 6.4, 11.0, 16.9, 24.1, and 41.7 percent in 1976.[5]

Timothy Smeeding has measured the effect of employer-provided fringe benefits (e.g., vacation and holiday pay, paid sick leave, insurance contributions, such as health or life, and deferred compensation, such as pension plans) on the degree of inequality.[6] Their effect is the opposite of that of government transfers in kind, although it is relatively small. Table 2 shows that the lowest quintile of workers receives 2.4 percent of all wages and salaries, but 2.2 percent of total compensation. A similar reduction occurs in the share of the lowest quintile of full-time full-year workers. The large differences in the measures between all workers and those working full-year full-time points out the large impact of unemployment on inequality and suggests the magnitude of the reduction in inequality that would result from full employment. Smeeding also suggests that if better measures of the job perquisites of high-income earners (e.g., stock option plans, expense accounts) were available, the inequality-increasing effect of fringes would increase. Thus, because government transfers in kind and fringe benefits have opposing effects, Census data, such as that reported in Table 1, probably overstate the extent of inequality to a small degree.[7]

THE ROLE OF DEMOGRAPHIC AND ECONOMIC FACTORS

In this section, the roles of several demographic and economic factors in accounting for the trend in inequality are examined. In recent years there has been a rapid change in the demographic composition of households. This change is evident in Table 3, where the population is divided into 12 exhaustive and mutually exclusive groups, distinguished by type of household unit (family or unrelated individual), sex of head, and age of head. The age categories are young (less than 25 years of age), prime-age (25-64), and aged (65 and over). Between 1965 and 1978, the total number of units grew by about 36 percent, while population grew by only about 12 percent. Families declined from 80 to 70 percent of all households, and the largest group of families, those with prime-age male heads, fell from 57.8 to 47.3 percent of all units. There was an increase in the percentage of units accounted for by all six groups of unrelated individuals, with the largest increases in units headed by women and the young.

Families headed by prime-age men have the highest mean income, while units headed by women, the aged, and the young have below average incomes. Thus, the demographic shift toward lower income units has tended to depress the mean income for all households and to increase the degree of inequality among households. Table 4 shows the mean Census income for each of the twelve demographic groups for 1965, 1972, and 1978. The income growth rates for ten of the twelve demographic groups exceeded the 16.3 percent aggregate growth in income for the 1965-1978 period. The same is true for the 1972-1978 subperiod, in which real incomes declined in the aggregate, even though they increased for eleven of the twelve groups.

Demographic change has contributed both to a decline in the growth rate of measured income and to an increase in income inequality. Table 5 reveals that the Gini coefficient for all units increased by 6.6 percent, while it actually decreased for seven of the groups.

Three economic factors are important determinants of the trend in household income inequality--income transfers, wives' contributions to family income, and the distribution of male earnings. For example, consider the group with the strongest labor market attachment--families headed by prime-aged men. Table 5 shows that their Gini coefficient increased by 3.7 percent. However, if it were not for income transfers, the increase would have been 8.1 percent. Table 6 shows the reduction in the Gini coefficient due to cash transfers in 1965 and 1978. In each year, transfers substantially reduced inequality, and this effect increased over time for each of the twelve groups.[8] The reduction in the Gini coefficient due to transfers--14.5 percent in 1978--is the largest single factor affecting inequality. This inequality-reducing impact of transfers is largest for aged household heads and for families headed by females because they are the primary beneficiaries of social security and welfare programs respectively.[9]

Table 7 shows that the earnings of wives have a small equalizing impact on the distribution of income among husband-wife families for white, nonwhite and Hispanic households. This effect has persisted over the recent past, even though the most rapid increases in work occurred among the wives of husbands with earnings above the median income. The Gini coefficient of family income was relatively constant for whites and fell slightly for nonwhites between 1965 and 1978, even though the Gini coefficients of husbands' earnings increased by about 11 percent for both white and nonwhite husbands.[10] Thus, the increased contributions of wives' earnings and of government transfers, which both tend to reduce inequality, offset the increased inequality of husbands' earnings.

Some portion of the increased earnings inequality among men can be accounted for by higher levels of unemployment and labor force withdrawal, attributable in part to rising transfers. However, Peter Henle and Paul Ryscavage even find a "slow but persistent" trend toward inequality among all wage and salary earners who worked year-round full-time and for eight of ten broad occupational groups.[11] These increases in earnings inequality are well-documented, but not very well understood.

There is little evidence to suggest that the recent increase in inequality will be reversed. The inequality-increasing effect of demographic change will be reduced somewhat by the aging of the baby boom and the reduction in new labor force entrants. Continued increases in the percentage of wives who work and of fringe benefits as a percent of total compensation should continue to have relatively small effects. In recent years, increased male earnings inequality has been offset by the growth of income transfers. Now, however, increased unemployment and reduced income transfers are both contributing to increased inequality.

THE DECLINE AND RISE OF POVERTY

The summary measures of inequality presented to this point are affected by changes in either the incomes of the poor or the nonpoor. However, it has often been argued that government policies should not be addressed to income distribution *per se*. For example, two Administration representatives recently wrote:

> Inequality of incomes in itself becomes something to be corrected only to the extent that the poorest do not have sufficient resources to provide for their needs.[12]

To reflect this concern with those at the bottom of the distribution, the remainder of this paper emphasizes the trend in poverty.

Table 8 shows the percentage of persons living in households with incomes below the poverty line. The results mirror those for inequality. First, over the 1965-1980 period poverty declined primarily because of transfers. In the absence of transfers, poverty would have declined by

6.1 percent. The official Census measure that includes cash transfers shows a decline of 16.6 percent, while the adjusted income measure, which accounts for in-kind transfers and federal taxes, shows a decline of almost 50 percent. Second, there was a large decline during the 1965-1972 period which was followed by stationary and then increasing poverty.

Again, there are large differences in economic status across the various demographic groups. For example, despite the growth of transfers, the official incidences of poverty in 1978 among children living in female-headed households were 31, 58, and 61 percent for whites, blacks, and Hispanics. Their number now, and the recent upward trend in the size of this group, refutes the view that poverty has been "virtually eliminated."[13] Between 1965 and 1978, welfare recipiency increased from 26 percent of all female heads to 38 percent; and the percentage of female heads who worked remained constant at about 65 percent. Thus, despite increased welfare recipiency, and the maintenance of work effort, poverty among female heads remains a serious problem.

Table 9 presents data on the dependence on cash transfers of all households and of pre-transfer poor households, classified by the age, sex, and race of the head. Over 40 percent of all households and 80 percent of pretransfer poor households received cash tranfers. For the poor, these transfers comprised 72.0 percent of their Census incomes. While the number of transfer recipients and the average benefit have grown in recent years, significant gaps in coverage and inadequacies in benefits remain. While almost all of the aged poor received transfers, almost 40 percent of nonaged poor households received none. And the probability of receiving enough aid to escape poverty is much lower among the nonaged than the aged.

Contrary to conventional wisdom, the receipt of transfers is quite similar regardless of race, once economic need has been taken into account. A greater percentage of all minority households receive transfers because they are more likely to be pretransfer poor. However, among the poor, whites are more likely than minorities to be removed from poverty by transfers because they receive larger amounts on average.

The recent growth of income transfer programs has had imortant beneficial effects--protection against income losses due to unemployment, retirement, disability and death; guarantees of access to minimum levels of food, shelter, and medical care; and the reduction of poverty and inequality. This growth has been accompanied by some declines in work effort and savings that have contributed to sluggish economic performance. But the magnitude of these disincentives has been overstated. A review of the available research indicates that the decline in aggregate work effort due to income transfers is less than 5 percent. The effect on savings is quite speculative—it ranges from zero to 20 percent.[14] These disincentives pose no serious threat to the growth of the economy, and they could be reduced by reforming the various programs. The elimination of the programs will lead to small gains in efficiency but large increases in inequality.

THE REAGAN ADMINISTRATION'S ECONOMIC PROGRAM: PROJECTED IMPACT ON THE INCOME DISTRIBUTION

The Reagan Administration has undertaken a "drastic fiscal retrenchment" to reduce government presence in the economy. Despite claims of evenhandedness, the new priorities reflect dissatisfaction with the growth of social welfare expenditures over the past fifteen years.

The program claims to maintain the "safety net" so as to insure the well-being of the "truly needy." However, the short-run direct effects of the Administration's program on poverty and inequality are clear. The tax changes will increase the disposable incomes of those toward the top of the income distribution and the budget changes, especially those in the income transfer programs will lower the incomes of those toward the bottom of the distribution. As a result, both poverty and income inequality will increase.

Consider the effects of the budget cuts on one of the poorest groups, female heads of household with children. They will be disproportionately affected. Many relied on CETA jobs. Others working in the private sector have either lost eligibility for Aid to Families with Dependent Children (which also results in a loss of Medicaid benefits) or have had their benefits significantly reduced by the new rules on work expenses and allowable assets. For example, the University of Chicago's Center for the Study of Welfare Policy showed that the typical AFDC mother who works would experience a 20 to 30 percent decline in her monthly income.[15]

Ironically, for many women the new AFDC rules provide less of an incentive to work than do the prior ones. For example, before the FY 1982 changes, the typical working welfare mother with one child in Wisconsin earned $432 per month, reported average work expenses of $108, and received $217 from AFDC. Her monthly disposable income was $140 higher than that of a nonworking AFDC mother with one child who received $401 per month. Now, after four months of welfare recipiency, her earnings reduce her welfare benefits even further, and she receives only $44 from AFDC. Her income after work expenses is actually $33 per month lower than that of the nonworking woman, and 32 percent below what it was in FY 1981. Given cases like this, it should come as no surprise that program administrators expect some of these women to quit working. If the woman in this example does quit, AFDC costs would not fall from $217 to $44, but would rise to $401.

Thus, at the same time as the proposed income tax reductions are cutting tax rates for the rest of the population, welfare beneficiaries who already face high benefit reduction rates (which are equivalent to tax rates) are experiencing even higher rates and work disincentives. If the lowered income tax rates lead the nonpoor to work more, as is hoped, and the higher rates lead welfare recipients to work less, the gap between the income classes will increase even more.

In addition to welfare women, many low-income two-parent working families in the second quintile of the income distribution will suffer large income losses. Households in this group have experienced the greatest reduction in their income share over the recent past, partly because their incomes are too high to qualify for government transfers and because their jobs are more cyclically sensitive and offer lower fringe benefits than those in the higher quintiles. They are now bearing the brunt of the increased unemployment rate in the private sector, and the reduction in employment and training programs. According to Lester Thurow, these programs accounted for 14 percent of the earnings received by the bottom two quintiles of the labor force.[16] These households now find that the extent of protection against income loss provided by food stamps and extended unemployment compensation in recent recessions has been reduced.

Minorities will also be disproportionately hurt because of the reductions in income transfers, employment and training programs and regular public sector empoyment. Michael Brown and Steven Erie show that in 1976 27 percent of all blacks as compared to 16 percent of all whites worked in the public sector.[17] About 55% of the net employment increase for blacks since 1960 occurred in the public sector, and much of the increase was in social welfare programs. Thus, reductions in government employment in general, and social welfare employment in particular, will affect blacks more than whites.

But, what of the supply-side miracle? Suppose that the Administration's program does succeed in stimulating economic growth. As suggested above, the major factor contributing to the reductions in poverty and offsetting increases in inequality was the growth in government transfers. Peter Gottschalk has examined the evidence concerning the trickle-down hypothesis.[18] He concludes that there is little reason to think that the earnings gains from economic growth that accrue to those with labor market disadvantages are likely to be large enough to significantly reduce poverty. He analyzed the economic situation of a sample of middle-aged married men over the 1966-1975 period and found that even though real earnings increased on average, inequality and the proportion of husbands with low earnings also increased. In fact, 43 percent of those with low earnings in a given year had low earnings in all six survey years, and 78 percent had low earnings more than half of the survey years. This indicates a good deal of permanence within the low earnings population, even during prosperous years.

Gottschalk also shows that, unless policies are implemented to alter the structure of the labor market facing the poor, then poverty would decline little in the 1980s even if unemployment remained at 6 percent and cash transfers grew as fast as national income.[19] Given the current high unemployment rates and the fiscal 1982 reductions in income transfers, he projects an incidence of poverty of 13.7 percent for 1981, the highest rate since 1967. If the proposed FY 1983 reductions in income transfer and other social programs are enacted, it is likely that the official incidence of poverty in 1984 will have returned to the levels that existed in the late 1960s, shortly after the declaration of the War on Poverty in 1964.

In sum, even if the Administration's program generates a recovery, the gains that trickle down to those at the bottom of the income distribution are not likely to be large enough to offset the direct losses from the reduced transfer and other social programs.

Notes and References

[1]Values of the Gini coefficient range from zero, which means perfect equality of income, to one, total inequality. Thus, a declining Gini coefficient means that the income distribution is becoming less unequal and a rising Gini coefficient means the income distribution is becoming more unequal.

[2]This point has also been made by Henry Reuss, "Inequality, Here We Come," Challenge, September/October 1981.

[3]Census money income is defined as money income received during the calendar year as wages and salaries, net income from self-employment, property income (for example, interest, dividends, and net rental incomes), government cash transfers, and other forms of cash income (for example, private pensions and alimony).

[4]These studies are reviewed in Sheldon Danziger, Robert Haveman, and Robert Plotnick, "How Income Transfer Programs Affect Work, Savings, and the Income Distribution: A Critical Review," Journal of Economic Literature, Vol. 19, September 1981.

[5]G. William Hoagland, "Measuring the Effectiveness of Current Transfer Programs in Reducing Poverty," in Welfare Reform in America, edited by P. Sommers (Martinus Nijhoff, 1982).

[6]Timothy Smeeding, "The Size Distribution of Wage and Nonwage Compensation," paper presented to the National Bureau of Economic Research Conference on Income and Wealth, October 1981.

[7]The overstatement of poverty in the Census data is much larger, as is shown below in Table 8. Fringe benefits do not increase poverty, so the poverty-reducing impact of government transfers in kind is not offset.

[8]The effect of tranfers on inequality is generally measured by comparing pretransfer and posttransfer incomes. Pretransfer income is defined by subtracting government transfers from posttransfer income. This definition assumes that transfers elicit no behavioral responses which would cause income without transfers to deviate from observed pretransfer income. However, transfers do induce labor supply reductions so that recipients' net incomes are not increased by the full amount of the transfer. For example, consider an individual who earns $3000. After the passage of a public assistance program, with an income guarantee of $3000 and a tax rate of 50%, the person reduces hours of work and earns $2500. A transfer of $1750 is now received and total income is $4250, but the individual's final income is only $1250 higher. Because pretransfer income in the absence of transfers is not observed, most studies measure the redistributive effect as the difference between pretransfer and posttransfer income ($4250-$2500), not as the increase in final income. Thus, true pretransfer income is likely to be higher than measured pretransfer income. Pre- post comparisons, therefore, such as the ones made here, are likely to provide upper-bound estimates of the effect of transfers on inequality.

[9]For example, in 1974 social security benefits were received by 22 percent of all families. They reduced the Gini coefficient by about 9 percent for all families, but by 29 percent for households headed by an aged person. Cash welfare benefits were received by 8 percent of families, reduced the Gini coefficient by 3 percent for all families and by 19 percent for families headed by a nonaged female. See Sheldon Danziger, "Income Redistribution and Social Security: Further Evidence," Social Service Review, Vol. 51, March 1977.

[10]Between 1967 and 1978, the Gini coefficient of earnings for white husbands increased from .394 to .437, or by 10.9 percent, while that of nonwhite husbands increased by 11.2 percent, from .392 to .436.

[11]Peter Henle and Paul Ryscavage, "The Distribution of Earned Income Among Men and Women, 1958-77," Monthly Labor Review, April 1980.

[12]Robert Carleson and Kevin Hopkins, "Whose Responsibiity is Social Responsibility: The Reagan Rationale," Public Welfare, Fall 1981.

[13]According to Martin Anderson, Welfare (Hoover Institution Press, 1978):

> The "war on poverty" that began in 1964 has been won. The growth of jobs and income in the private economy, combined with an explosive increase in government spending for welfare and income transfer programs, has virtually eliminated poverty in the United States.

[14]Danziger, Haveman, and Plotnick, op. cit.

[15]University of Chicago, Center for the Study of Welfare Policy. "The Poor: Profiles of Families in Poverty," mimeographed (Washington, D.C.: March 20, 1981).

[16]Lester Thurow, "Equity, Efficiency, Social Justice and Redistribution," Nebraska Journal of Economics and Business, Vol. 20, Spring 1981.

[17]Michael Brown and Steven Erie, "Blacks and the Legacy of the Great Society," Public Policy, Vol. 29, Summer 1981. Thurow, op cit. also points out that the ratio of black to white wages is higher in the public than the private sector.

[18]Peter Gottschalk, "Earnings Mobility: Permanent Change or Transitory Fluctuations," Review of Economics and Statistics, 1982, in press.

[19]Peter Gottschalk, "Transfer Scenarios and Projections of Poverty into the 1980s," Journal of Human Resources, Vol. 16, Winter 1981.

Table 1

The Trend in Income Inequality, Selected Years, 1950-1979

	Share of Census Money Income Received by Quintile: 1	2	3	4	5	Gini Coefficient
A. All Households (Families and Unrelated Individuals)[a]						
1979	3.8	9.7	16.4	24.8	45.3	.419
1975	3.9	9.9	16.7	24.7	44.5	.411
1970	3.6	10.3	17.2	24.7	44.1	.407
1970	3.8	10.7	17.5	24.7	43.4	.399
1965	3.6	10.6	17.5	24.8	43.6	.403
1960	3.2	10.6	17.6	24.7	44.0	.410
1950	3.1	10.6	17.3	24.4	44.9	.417
B. All Families[b]						
1979	5.3	11.6	17.5	24.1	41.6	.365
1975	5.4	11.8	17.6	24.1	41.1	.358
1970	5.4	12.2	17.6	23.8	40.9	.354
1966	5.6	12.4	17.8	23.8	40.5	.349
1965	5.2	12.2	17.8	23.9	40.9	.356
1960	4.8	12.2	17.8	24.0	41.3	.364
1950	4.5	12.0	17.4	23.4	42.7	.379

Source: U.S. Department of Commerce, Bureau of the Census, "Money Income of Families and Persons in the United States: 1979." Current Population Reports, Series P-60, No. 129, November, 1981, Table 14.

[a]The 1979 income cutoffs for the quintiles of families and unrelated individuals are $6,212, $11,970, $18,795, and $27,982.

[b]The 1979 income cutoffs for the quintiles of families are $9,830, $16,220, $22,985 and $31,590.

Table 2

The Size Distribution of Wages and Salaries and of Total Compensation, 1979[a]

	Income Share of Quintile:			Gini Coefficient
	1	2+3+4	5	
All Workers				
Wages and Salaries	2.4	50.3	47.3	.453
Total Compensation	2.2	50.1	47.7	.459
Full-Year Full-Time Workers[b]				
Wages and Salaries	8.0	53.2	38.0	.310
Total Compensation	7.8	53.4	38.8	.313

Source: Timothy M. Smeeding, "The Size Distribution of Wage and Nonwage Compensation," paper presented to the National Bureau of Economic Research Conference on Income and Wealth, October 1981.

[a]Total compensation represents costs to employer of pay for time worked and of deferred compensation and insurance contributions.

[b]Full-year full-time workers work 35 or more hours per week, for 50 weeks per year or more.

Table 3

Demographic Composition of Households, Selected Years, 1965-1978[a]

	1965	1972	1978
FAMILIES HEADED BY:			
Young Males	4.4%	5.1%	3.7%
Prime-Age Males	57.8	53.1	47.3
Aged Males	9.6	9.0	8.9
Young Females	0.5	0.9	1.0
Prime-Age Females	6.0	6.8	7.8
Aged Females	1.7	1.6	1.5
All Families	80.0	76.5	70.2
INDIVIDUALS WHO ARE:			
Young Males	0.7	1.9	2.9
Prime-Age Males	4.9	5.5	8.0
Aged Males	2.0	2.0	2.1
Young Females	1.4	1.7	2.7
Prime-Age Females	5.4	5.9	7.0
Aged Females	5.7	6.6	7.2
All Individuals	20.1	23.6	29.9
TOTAL	100.0	100.0	100.0
Number of Households (millions)	60.4	70.9	82.4

Source: Updated version of table from Sheldon Danziger and Robert Plotnick, "Demographic Change, Government Transfers, and Income Distribution," Monthly Labor Review, April 1977.

[a]Totals may not add to 100.0 because of rounding.

Table 4

Mean Census Money Income by Demographic Group, Selected Years, 1965-1978[a]

	Mean Income:			Percentage Change		
	1965	1972	1978	1965-72	1972-78	1965-7
FAMILIES HEADED BY:						
Young Males	$12,118	$13,595	$14,457	12.2%	6.3%	19.3%
Prime-Age Males	18,613	23,146	23,838	24.4	3.0	28.1
Aged Males	10,997	13,068	14,129	18.8	8.1	28.5
Young Females	5,290	5,010	5,494	-5.3	9.7	3.9
Prime-Age Females	9,635	10,960	11,055	13.8	0.9	14.7
Aged Females	10,396	12,868	12,159	23.8	-5.5	17.0
INDIVIDUALS WHO ARE:						
Young Males	5,430	7,079	7,623	30.4	7.7	40.0
Prime-Age Males	9,956	12,990	13,498	30.5	3.9	35.6
Aged Males	4,955	6,290	6,911	26.9	9.9	39.5
Young Females	3,921	5,021	6,027	28.0	20.0	53.7
Prime-Age Females	7,661	8,482	9,151	10.7	7.9	19.4
Aged Females	4,060	5,104	5,725	25.7	12.2	41.0
TOTAL	14,454	17,038	16,815	17.9	-1.3	16.3

Source: See Table 3.

[a]All incomes are expressed in 1978 dollars.

Table 5

Inequality in the Distribution of Census Money Income
1965 and 1978

	1 1965 Gini Coefficient	2 1978 Gini Coefficient	3 Percent Change[a]
FAMILIES HEADED BY:			
Young Males	.279	.278	-0.4%
Prime-Age Males	.300	.311	3.7
Aged Males	.437	.406	-7.1
Young Females	.438	.445	1.6
Prime-Age Females	.375	.396	5.6
Aged Females	.405	.378	-6.7
INDIVIDUALS WHO ARE:			
Young Males	.445	.385	-13.5
Prime-Age Males	.403	.409	1.5
Aged Males	.378	.413	9.3
Young Females	.518	.403	-22.2
Prime-Age Females	.423	.402	-5.0
Aged Females	.416	.375	-9.9
TOTAL	.392	.418	6.6

Source: Table 3.

[a]Defined as ((1978 Gini - 1965 Gini)/1965 Gini) · 100.

Table 6

Percent Change in Gini Coefficient due to Cash Transfers, 1965 and 1978

	Change in Gini Coefficient[a]	
	1965	1978
FAMILIES HEADED BY:		
Young Males	-2.1%	-3.8%
Prime-Age Males	-3.2	-7.2
Aged Males	-32.6	-37.5
Young Females	-25.3	-32.4
Prime-Age Females	-22.4	-21.6
Aged Females	-24.4	-37.3
INDIVIDUALS WHO ARE:		
Young Males	-2.6	-3.8
Prime-Age Males	-7.8	-6.8
Aged Males	-46.9	-45.7
Young Females	-0.5	-4.3
Prime-Age Females	-10.8	-13.9
Aged Females	-44.0	-49.5
TOTAL	-11.1	-14.5

Source: See Table 3.

[a]Defined as (100. (Posttransfer Gini - Pretransfer Gini)/ Pretransfer Gini).

Table 7

Working Wives and Family Income Inequality[a]

	Mean Income[b]		Gini Coefficient	
	1967	1978	1967	1978
Whites				
Total Family Income	$9379	$21,730	.323	.322
Total Family Income Less Wives' Earnings	8130	18,342	.339	.343
Change due to Wives' Earnings	15.4%	18.5%	-4.6%	-6.1%
Nonwhites				
Total Family Income	$6702	$18,439	.350	.335
Total Family Income Less Wives' Earnings	5319	13,980	.345	.343
Change due to Wives' Earnings	26.0%	31.9%	+1.4%	-2.3%
Hispanics				
Total Family Income	n.a.	$16,502	n.a.	.322
Total Family Income Less Wives' Earnings	n.a.	13,628	n.a.	.334
Change due to Wives' Earnings	n.a.	21.7%	n.a.	-3.5%

Source: Updated version of Table 2, from Sheldon Danziger, "Do Working Wives Increase Family Income Inequality?" _Journal of Human Resources_, Vol. 15, Summer 1980.

[a]Families include only those households with husband and wife present.

[b]Current dollars.

n.a. Not available.

Table 8

Persons Living Below Official Poverty Lines, 1965-1980
(Percentages)

	Census Money Income	Adjusted Income	Census Money Income Less Transfers
1965	15.6	12.1[a]	21.3
1968	12.8	9.9	18.2
1970	12.6	9.3	18.8
1972	11.9	6.2	19.2
1974	11.6	7.2	20.3
1976	11.8	6.7	21.0
1978	11.4	n.a.	20.2
1980	13.0	6.1	20.0[a]
Percentage & Change			
1965-72	-23.7	-48.8	-9.9
1972-80	+9.2	-1.6	+4.2
1965-80	-16.6	-49.6	-6.1

Source: Sheldon Danziger and Robert Plotnick, "The War on Income Poverty: Achievements and Failures," in Welfare Reform in America, edited by P. Sommers (Boston: Martinus Nijhoff, 1982); adjusted income is from Timothy Smeeding, "The Antipoverty Effect of In-Kind Transfers: A 'Good Idea' Gone Too Far?" Policy Studies Journal, 1982, in press.

[a]Estimate.

Table 9

Dependence on Cash Transfers, All Households and Pretransfer Poor Households, 1978

Household Head	All Households: Percentage Receiving Cash Transfers	All Households: Cash Transfers as a Percentage of Census Money Income	Pretransfer Poor: Percentage Receiving Cash Transfers	Pretransfer Poor: Cash Transfers as a Percentage of Census Money Income
Nonaged Males				
White	25.1%	4.1%	59.6%	62.7%
Nonwhite	31.5	5.2	59.9	43.0
Hispanic	25.7	4.5	44.3	34.7
Nonaged Females				
White	32.9	10.4	61.3	60.1
Nonwhite	53.7	21.3	76.8	62.4
Hispanic	50.4	23.4	73.8	72.7
Aged Males and Females				
White	95.9	44.8	98.9	83.1
Nonwhite	95.7	54.8	97.9	83.3
Hispanic	93.9	46.5	98.5	82.5
Totals	41.8	10.8	80.3	72.0

Source: Sheldon Danziger and Robert Plotnick, "The Receipt and Antipoverty Effectiveness of Cash Income Maintenance Transfers." Institute for Research on Poverty Discussion Paper, December 1981.

University of Wisconsin-Madison

Institute for Research on Poverty

Discussion Papers

Sheldon Danziger

CHILDREN IN POVERTY: THE TRULY NEEDY WHO FALL THROUGH THE SAFETY NET

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Children in Poverty: The Truly Needy Who Fall Through the Safety Net

Sheldon Danziger
School of Social Work and
Institute for Research on Poverty,
University of Wisconsin-Madison

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ABSTRACT

The Reagan administration's program of fiscal retrenchment has resulted in budget cuts that disproportionately affect social welfare programs. Although administration policy claims to ensure the well-being of the "truly needy," a review of the evidence on the trend in poverty suggests that the administration's program both exaggerates the extent to which poverty has been reduced and understates the contributions of social welfare programs to the well-being of the poor.

This paper suggests that the Reagan program will result in an increase in poverty incidence, especially among households with children. Despite the past growth in social welfare expenditures and a general decline in poverty, among families with children poverty has declined little since 1965. In households headed by women with children, poverty remains at very high levels. After a review of how budget cuts will affect households with children, the paper discusses alternative policies to reduce poverty.

Children in Poverty: The Truly Needy Who Fall Through the Safety Net

INTRODUCTION

The Reagan administration has undertaken a "drastic fiscal retrenchment" to reduce government presence in the economy. Despite claims of evenhandedness, the new priorities reflect dissatisfaction with the growth of social welfare expenditures over the past fifteen years. As a result, the cuts disproportionately affect social welfare programs. The policy claims to maintain the "safety net" so as to ensure the well-being of the "truly needy." Yet a review of the evidence on the trend in poverty suggests that the Reagan program both exaggerates the extent to which poverty has been reduced, particularly the incidence of poverty for households with children, and understates the contributions of social welfare programs to the well-being of those with low incomes.

This paper suggests that the Reagan program will lead to increases in the incidence of poverty, especially among households with children under the age of 18. The evidence reveals that despite the growth in social welfare expenditures and the decline in poverty in the population at large, poverty among households with children has declined only slightly since 1965. In addition, poverty remains at very high levels for children living in households headed by women, and recently this has been the most rapidly growing type of household. After a brief review of how the Reagan cuts will affect households with children, the paper discusses alternative policies that offer promise for reducing poverty.

FROM THE WAR ON POVERTY TO THE REAGAN BUDGET CUTS

With the passage into law of the Economic Opportunity Act of 1964, the nation declared its intent to wage war on the low levels of living endured by its poorest citizens. One goal of the War on Poverty was to provide opportunities for the children of the poor. Access to education and training and to minimum levels of food, shelter, and medical care were to remove the barriers keeping these children from economic and social progress. In his 1964 State of the Union Message declaring war on poverty, President Johnson stated:

> Our chief weapons . . . will be better schools, and better health, and better homes, and better training, and better job opportunities to help more Americans, especially young Americans escape from squalor and misery and unemployment rolls.

Several months later, when he submitted the Economic Opportunity Act to Congress, he re-emphasized that the plight of the young was a primary concern:

> The young man or woman who grows up without a decent education, in a broken home, in a hostile and squalid environment, in ill health or in the face of racial injustice--that young man or woman is often trapped in a life of poverty.

As a result of the War on Poverty and the effort to build the Great Society, many programs which later grew to spend billions of dollars for the benefit of the young were enacted into law. These included Head Start, the Elementary and Secondary Education Act, Basic Educational Opportunity Grants, and the Job Corps, to name a few. In subsequent years, benefit levels were increased and eligibility requirements were liberalized in existing programs--e.g., Food Stamps, Aid to Families with Dependent Children (AFDC). The comprehensiveness of the strategies represented a reorientation of all domestic policies toward a concern with poverty. Of course, much of the growth in social welfare expenditures in the last 15 years, especially in social security benefits, was motivated by social goals other than the enhancement of opportunities for the young and the poor. Taken together, social welfare programs, new and expanded, were 11.7 percent of GNP in 1965 and 19.3 percent in 1978 (Lampman, 1980).

President Reagan's budget cuts are designed to reduce government presence in the civilian economy. Both the magnitude of the cuts and their allocation among programs represent a sharp break with the past. Their major goal is to curtail the growth of entitlements and to make room in the budget for increased military spending. Social welfare expenditures have been singled out for special attention because

> our society's commitment to an adequate social safety net contains powerful, inherently expansionary tendencies. If left unchecked, these forces threaten eventual fiscal ruin and serious challenges to basic social values of independence and self-support. The Federal Government has created so many entitlements for unnecessary benefits that it is essential to begin paring them back (Reagan, 1981).

Whereas the War on Poverty reflected the view that public expenditures had to be increased to stimulate opportunities for the poor, the Reagan approach appears to be that public expenditures on behalf of the poor have to be decreased so that tax cuts to stimulate opportunities for the nonpoor can be afforded. Benefits to the nonpoor are then presumed to trickle down to the few remaining poor. The administration's program is based in part on the writings of Martin Anderson, now chief domestic policy advisor, who argues:

> The "war on poverty" that began in 1964 has been won. The growth of jobs and income in the private economy, combined with an explosive increase in government spending for welfare and income transfer programs, has virtually eliminated poverty in the United States (Anderson, 1978, p. 37).

The data presented below show that Anderson exaggerates the extent of the reductions in poverty, and that some of the Reagan initiatives are ill-timed, at best.

INCOME MAINTENANCE PROGRAMS AND THE TREND IN POVERTY

Table 1 shows the importance of cash income maintenance transfers as a component of household income.[1] In 1978, 41.8 percent of all households received a cash transfer from one of the major income maintenance programs (all listed in note to the table). These transfers totalled over $200 billion and constituted 10 percent of total household income. While households with children accounted for about 40 percent of all households, they received only about 23 percent of all transfers. This reflects the "pro-aged tilt" of the income maintenance system, since social security benefits account for about 60 percent of all cash transfers (Danziger and Plotnick, 1981). Thus, the aged, who constituted about 20 percent of households, received over half of the total transfers. While a household headed by a nonaged transfer recipient received, on the average, a transfer of $3,275 in 1978, the typical aged recipient, living in a smaller household, received $4,739.

Table 1

Cash Income Maintenance Transfers as a Component of Household Income, 1978

Characteristics of Household Head	Number of Households (millions)	Percentage of All Households	Mean Census Income	Percentage of Income from Cash Transfers	Percentage Receiving Transfers	Percentage of Total Transfers
No Children						
Nonaged Male	25.35	30.8%	$19,320	5.4%	28.4%	19.5%
Nonaged Female	9.48	11.5	9,586	8.1	28.0	5.4
Aged	15.59	18.9	9,818	46.2	96.0	52.2
Children						
Nonaged Male	25.67	31.2	22,147	3.1	23.3	13.0
Nonaged Female	5.76	7.0	8,792	21.5	55.6	8.0
Aged	0.53	0.6	14,855	31.4	92.0	1.8
All Households	82.38	100.0	16,518	10.0	41.8	100.0

Source: Computations by author from March 1979 Current Population Survey.

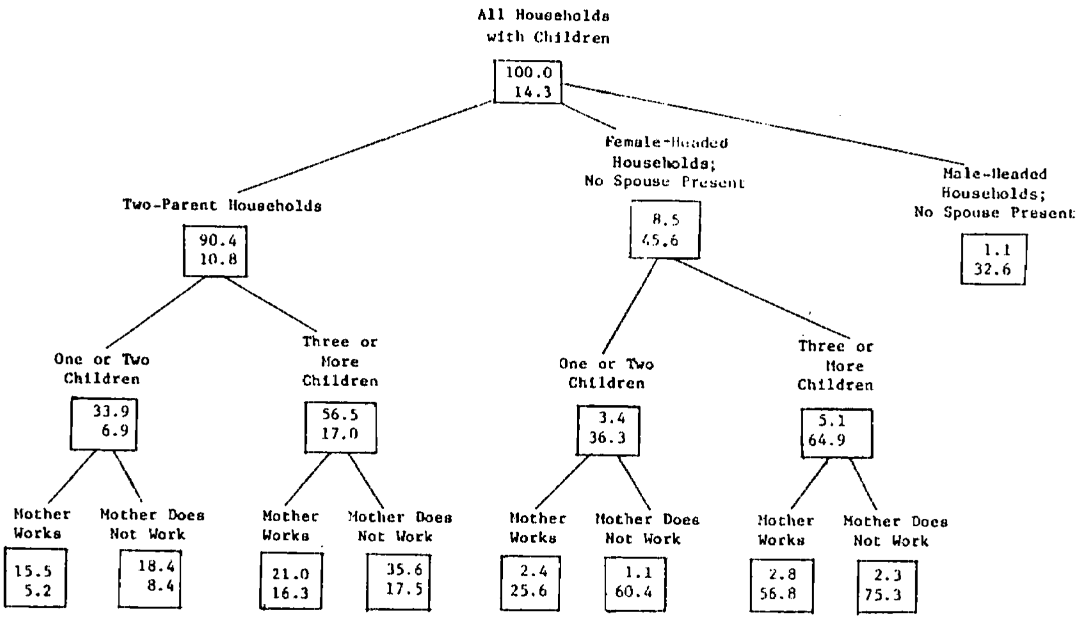
Note: Cash income transfers reported in the CPS include Social Security, Railroad Retirement, Aid to Families with Dependent Children, Supplemental Security Income, General Assistance, Unemployment Compensation, Workers' Compensation, Government Employee Pensions, and Veterans' Pensions and Compensation. Census income includes, in addition to cash transfers, money wages and salaries, net income from self-employment, property income, and other forms of cash income such as private pensions and alimony. Nonaged are persons less than 65 years of age; aged are 65 years or older.

Table 1 also shows that the demographic group with the lowest mean census income is nonaged female-headed households with children. Their total cash income, $8,792, is about one-half the average for all households, despite the fact that 55.6 percent of these households receive transfers, which account for 21.5 percent of their cash income. This suggests that existing programs do reach the needy, but that average benefit levels are low.

Figures 1 and 2, for 1965 and 1978, present the distribution of children across household types, classified by number of parents, number of children, and employment status of the mother. Households without children are not included. The top number in each box is the percentage of all children who live in that household type; the bottom number is the officially measured incidence of poverty for these households.[2] Between 1965 and 1978, poverty in households with children declined from 14.3 to 13.2 percent. This decline represents a change in incidence of 7.7 percent.[3] Over this period, the incidence for <u>all</u> households declined from 17.2 to 13.0 percent, a decline of 24.4 percent.

The data shown fail to reflect two important points. First, there are large variations in poverty across racial and ethnic groups. In 1978, 9 percent of white, 33 percent of black, and 20 percent of Hispanic households with children were poor. Second, Smeeding (1982) suggests that if in-kind transfers for food, housing, and medical care were counted as income, the incidence of poverty would be about one-half that shown by the official measure. However, the large differences in poverty by household type would remain.

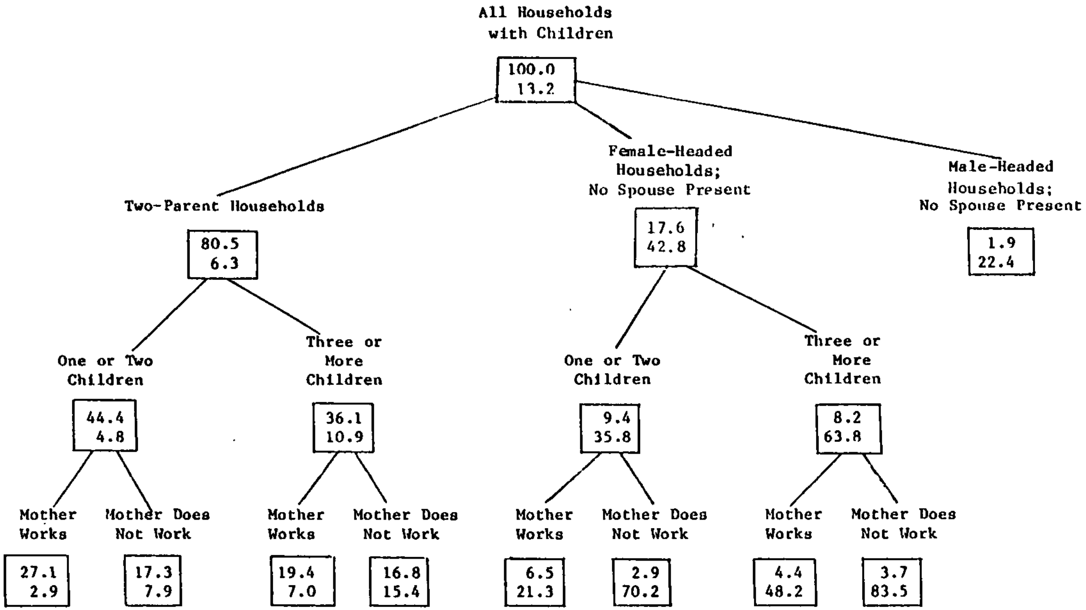
Figure 1: The Distribution of Children Across Household Types and the Incidence of Poverty, 1965



Source: Computations by author from 1966 Survey of Economic Opportunity.

Note: The top number in each box is the percentage of all children who live in the household type; the bottom number, the incidence of poverty for households in that category.

Figure 2: The Distribution of Children Across Household Types and the Incidence of Poverty, 1978



Source: Computations by author from March 1979 Current Population Survey.

Note: The top number in each box is the percentage of all children who live in the household type; the bottom number, the incidence of poverty for households in that category.

While the incidence of poverty for households with children fell less than the incidence for all households, there were large differences between two-parent and one-parent households with children. The incidence for two-parent households is below the aggregate incidence in each year, and the 42 percent decline from 10.8 to 6.3 percent was more rapid than the aggregate. However, the percentage of children living in this type of household declined from about 90 to about 80 percent. Those living in one-parent, female-headed households doubled, from 8.5 to 17.6 percent, and those in one-parent, male-headed families rose, from 1.1 to 1.9 percent. (Because these male-headed households contain so small a proportion of all children, detailed data relating to them are not shown, and the rest of the discussion will not address them.)

The fact that a greater percentage of children are living in female-headed households, a group for whom the official incidence of poverty remains above 40 percent, forms the core of the current poverty problem. Their number now, and the recent upward trend in the size of this group, refutes the view that poverty has been "virtually eliminated."[4] Indeed, the poverty problem is even more severe for black and Hispanic children. A breakdown of the data in Figure 2 for female-headed households reveals that the percentages of children living in this type of household were 12, 43, and 20 percent respectively for whites, blacks, and Hispanics, and that the incidences of poverty were 31, 58, and 61 percent. Given these high incidences of poverty, despite increased social welfare expenditures, for such a large percentage of children, it seems inappropriate even to employ the term "safety net."

The figures reveal two patterns that are similar in each year for both one- and two-parent households. First, households with three or four children are about twice as likely to be poor as those with one or two children, and households where the mother does not work in the paid labor force are about twice as likely to be poor as those where the mother works. Thus, the increases in the percentage of children whose mothers work and the decreases in the percentage living in households with three or more children contributed to the observed decline in poverty.

Table 2 shows for 1978 the predicted incidence of poverty before and after government transfers, and the antipoverty effectiveness of transfers, for families who have children and are headed by a parent capable of working. The poverty incidences are derived from a set of logistic regressions that provide comparisons across demographic groups for households with the same personal characteristics. A separate regression was estimated for each of the six types of household heads shown and for pretransfer and official poverty. The coefficients were then used to predict the incidence of poverty for a household head who is between the ages of 35 and 54, has completed 8 to 11 years of school, lives in a metropolitan area in the Northeast region, is not disabled, and heads a family of three or four. The female head is divorced or separated; the male head is married.[5]

The results complement the data shown in Table 1 concerning the contribution of transfers to mean incomes. Transfers substantially reduce poverty for female heads of household with children and for non-white and Hispanic male heads. In addition, Plotnick (1979) has shown

Table 2

The Predicted Incidence of Poverty and the Antipoverty Effectiveness of Transfers, 1978

Household Head[a]	Pretransfer Poverty[b]	Official Measure of Poverty[b]	Percentage Change Due to Transfers[c]
Married Male			
White	6.85%	6.68%	-2.5%
Nonwhite	12.72	9.75	-23.3
Hispanic	9.23	5.59	-39.4
Divorced or Separated Female			
White	52.22	39.38	-24.6
Nonwhite	65.40	54.96	-15.4
Hispanic	73.29	61.09	-16.6

Source: Derived from regressions estimated by author from March 1979 Current Population Survey.

[a]Head is 35-54 years of age, has completed 8 to 11 years of school, lives in a metropolitan area in the Northeast region, is not disabled, heads a family of three or four persons.

[b]Pretransfer poverty is computed by subtracting income derived from government cash transfers from census money income. The official measure of poverty is based on census money income and includes government cash transfers.

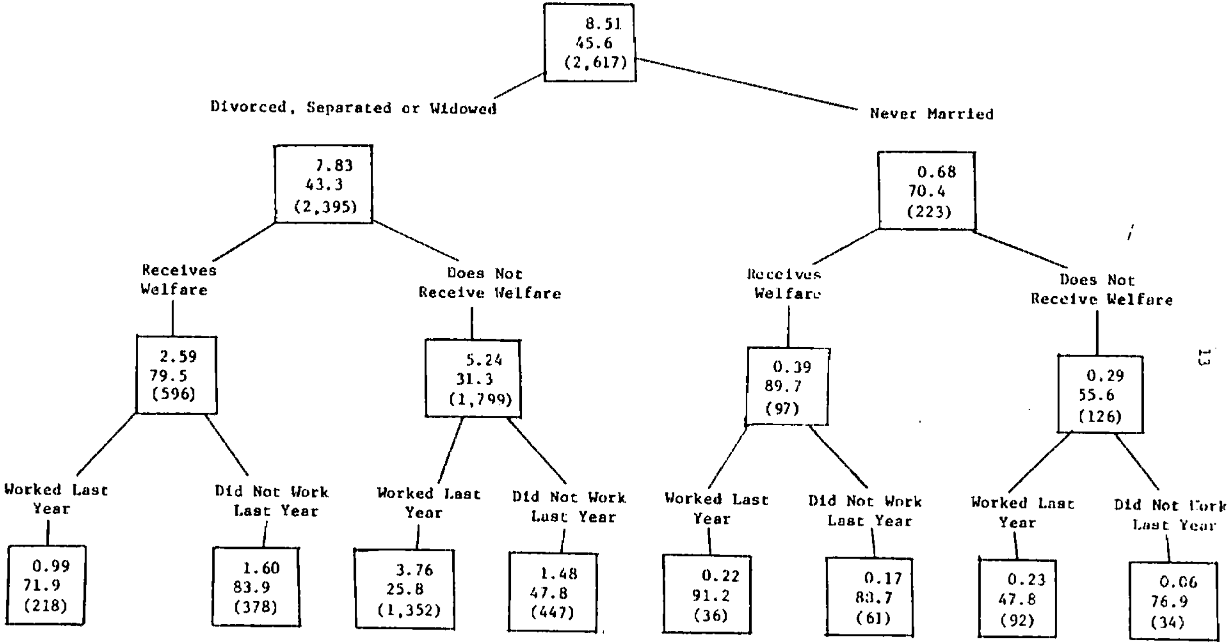
[c]Defined as (Official - Pretransfer/Pretransfer) x 100.

that over three-quarters of welfare transfers and one-half of social insurance transfers are received by the poor. These results challenge the Reagan administration's assertions that current programs are not well-targeted on the truly needy.

Figures 3 and 4 for 1965 and 1978 further classify female-headed households with children by marital status, welfare recipiency, and employment status. Poverty declined from 45.6 to 42.8 percent for all of these households, but in 1978 it remains above 80 percent for several of the categories. Among female-headed households, those in which the mother was never married, received welfare, and did not work last year generally have the highest incidences of poverty in both years. For example, 94.9 percent of those who never married, received welfare, but did not work in 1978 were poor. Between 1965 and 1978, the number of divorced, separated, or widowed female heads with children increased by 94 percent, while the number of never-marrieds increased by 378 percent; welfare recipiency increased from 26 percent of all female heads to 38 percent; and the percentage of female heads who worked remained constant at about 65 percent. Thus, despite increased welfare recipiency and the maintenance of work effort, poverty among households headed by women declined only slightly.[6]

Clearly, poverty remains a problem despite the growth in social welfare benefits. The next section reviews the Reagan cuts and speculates on their effects on the poor.

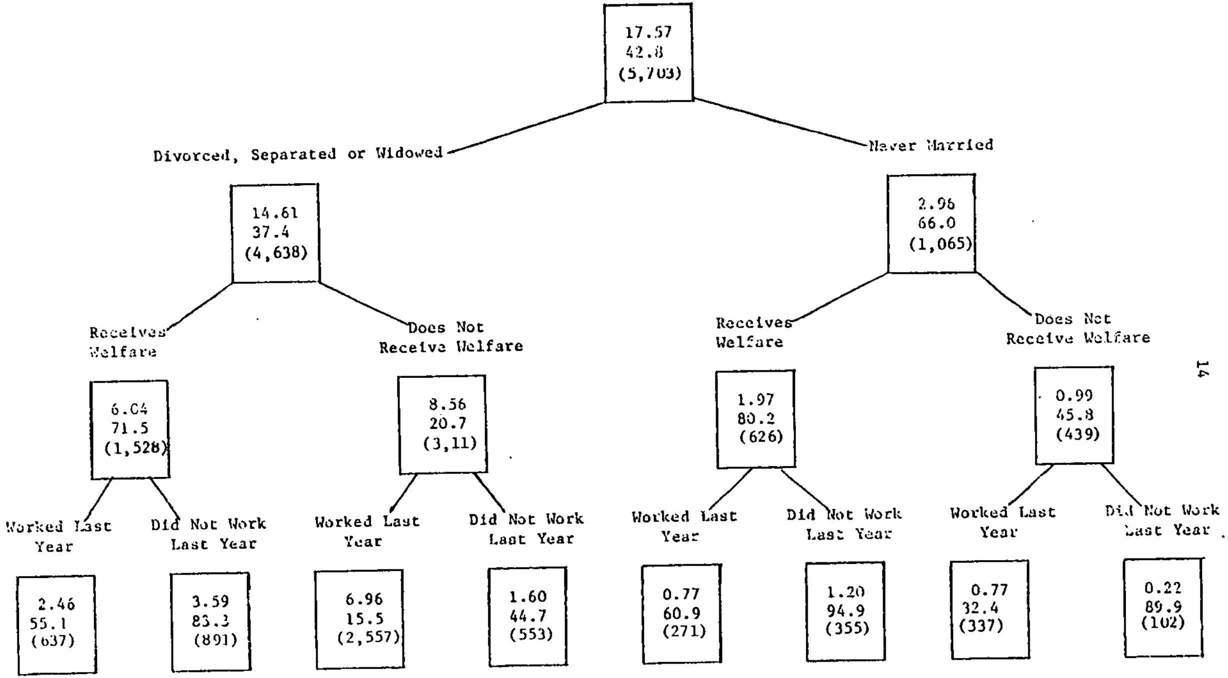
Figure 3: Incidence of Poverty and Distribution of Children among Households Headed by Women, 1965



Source: Computations by author from 1966 Survey of Economic Opportunity.

Note: The top number in each box is the percentage of all children who live in the household type; the second number, the incidence of poverty for households of that type; the number in parentheses is the number of households (in thousands).

Figure 4: Incidence of Poverty and Distribution of Children among Households Headed by Women, 1978



Source: Computations by author from March 1979 CPS.

Note: The top number in each box is the percentage of all children who live in the household type; the second number, the incidence of poverty for households of that type; the number in parentheses is the number of households (in thousands).

THE REAGAN BUDGET CUTS

President Reagan initially proposed budget cuts for fiscal year 1982 that were about $44 billion, or 5.7 percent, less than the Carter administration's proposals for that year. Over half of the total cuts were in the budget categories in which most benefits are targeted to the poor and/or children: income security, education, training, employment, and social services. Thus, even though the president claims to be protecting the "truly needy," they will be adversely affected. For example, the Congressional Budget Office (1981a) estimates that the reductions in expenditures for Title I of the Elementary and Secondary Education Act would correspond to less than a 1 percent reduction in a typical school district, but to a 6 to 7 percent reduction in a poor district. The cutbacks in the Food Stamp, School Lunch, Legal Services, Basic Educational Opportunity Grants, and CETA Public Service Employment programs will all have the effect of reducing the transfers received by the poor as well as their opportunities to earn their way out of poverty and unemployment through schooling, training, or work.

Women heading families with children have low mean incomes and high poverty rates despite their heavy reliance on social welfare benefits. The budget cuts will disproportionately affect them. Many relied on CETA jobs. Others working in the private sector will either lose eligibility for Aid to Families with Dependent Children or have their benefits significantly reduced by the new rules on work expenses and allowable assets. For example, the University of Chicago's Center for the Study of Welfare Policy (1981) shows that the typical AFDC mother who works will experience a 20 to 30 percent decline in her monthly income.

Ironically, for many women the new AFDC rules provide less incentive to work than do current ones. For example, the Chicago Center's study shows that in New York the typical working welfare mother with two children earns \$396 per month. Because these earnings reduce her Food Stamp and AFDC benefits, her monthly disposable income is currently \$162 higher than that of a nonworking mother with two children. Thus, her effective benefit reduction rate is 59 percent (\$396-162/396 = 0.59). Under the Reagan proposals, after four months of welfare recipiency, her earnings would reduce her welfare benefits even further, and her disposable income would be only \$15 per month higher than that of the nonworking woman. In this case, the effective benefit reduction rate would be 96 percent, and one might expect the woman to quit working. Some Food Stamp and AFDC recipients will find that additional earnings will bring them to a "notch"--a point at which their eligibility will be terminated and their benefits will fall by more than the amount of the additional earnings. Loss of Medicaid will be widespread, making the notch problem more serious. Some of those whose eligibility is terminated may also reduce their work effort so as to regain eligibility.

Thus, at the same time that the proposed income tax reductions will be cutting tax rates for the rest of the population, many lower-income families who receive welfare benefits and already face high benefit reduction rates (which are equivalent to tax rates) will experience even higher rates and work disincentives.[7] If the lowered income tax rates lead the nonpoor to work more, and the higher rates lead welfare recipients to work less, the gap between the income classes will increase.

SOME ALTERNATIVES FOR POOR HOUSEHOLDS WITH CHILDREN

Income maintenance policy must confront the financial plight of children, especially those living in female-headed households. Over 40 percent of these households remain poor even though over half receive income transfers (about 40 percent receive welfare) and about two-thirds of the women work at least part time. The budget changes that have already been implemented will further aggravate the problem. And if the current system of open-ended matching grants for AFDC is replaced by fixed block grants of equal size (as proposed by the Reagan administration), real benefits will decline even further (Chernick, 1982).

A welfare reform that would have alleviated poverty to some extent among female-headed households was proposed by President Carter in 1977. It was not enacted, primarily because it would have added to the costs of current programs (Danziger, Haveman, and Smolensky, 1977; Danziger and Plotnick, 1979). But there seems to be no welfare reform that can reduce poverty among women heading households with young children that does not also increase transfer expenditures.

One solution (Jones, Gordon and Sawhill, 1976; Cassetty, 1978; Garfinkel, 1979) would be a new social child support program, which would replace AFDC and the current role played by the courts. All adults not living with a spouse who care for children would be eligible for a public payment that would be financed by a tax on the absent parent. If the payment fell below a minimum level, it would be supplemented up to that level by government funds. The program could reduce poverty even if total government expenditures were maintained at current funding levels because of the additional revenue raised from absent parents.

A second policy to aid households with children involves expansion of the Earned Income Tax Credit (EITC), which currently subsidizes the earnings of workers who have children and whose incomes are below $10,000 a year. By increasing the subsidy rate, work incentives for the lowest-income workers would be enhanced. Some workers now above the eligibility cutoff would receive a subsidy, but would also experience an increase in their marginal tax rate. On balance, expanding the EITC would offset the toll which inflation has taken and would reduce the tax burdens of the working poor. Due to increases in the standard deduction and personal exemptions, and to the introduction of the EITC, federal income and payroll taxes for a poverty-line family of four declined from 7.6 percent of family income in 1969 to less than 2 percent in 1979. However, because the poverty line is indexed but the EITC is not, and because the poverty-line family gets almost no relief from the Reagan tax cuts, its 1981 average tax rate will be as high as it was in 1969. An expansion of the EITC would give some relief to working poor and near-poor families who lose benefits from the proposed spending cuts.

Finally, there are ways to cut the budget without disproportionately hurting households with children, even if the administration refuses to roll back significantly its large increases in military expenditures. Some proposals of this type are presented in a recent report by the Congressional Budget Office (1981b). The CBO estimates, for example, that repeal of the consumer interest deduction from the personal income tax could raise an additional $6 billion in 1982. This deduction promotes consumption by subsidizing personal debt rather than saving, and is of benefit only to taxpayers who itemize, a group that has above-average incomes.

The cutbacks in social welfare programs have deflected attention away from the plight of those who remain poor. If the administration continues to attribute most of the problems of the economy to the ill effects of social programs and accordingly reduces expenditures even further, poverty may rise to the level prevailing at the outset of the War on Poverty, and the progress made during the last 15 years will be lost.

NOTES

[1]The computer tapes from the March 1979 Current Population Survey and the 1966 Survey of Economic Opportunity are the sources for the data presented in this paper. The surveys report number of households as of March of the survey year, but census money income for the previous year. Census money income is defined as money income received during the calendar year as wages and salaries, net income from self-employment, property income--for example, interest, dividends, and net rental incomes--government cash transfers from the programs listed in the note to Table 1, and other forms of cash income, such as private pensions and alimony. The census income concept does not include government or private benefits in-kind, such as Medicare, Food Stamps, housing assistance, or employer-provided health insurance. The omission of in-kind transfers biases downward estimates of the number of transfer recipients and biases upward estimates of the incidence of poverty. Plotnick and Smeeding (1979) show that in 1974 an additional 2 to 3 percent of the population received in-kind transfers for food, housing and/or medical care, but did not receive cash transfers. This suggests that the percentage receiving either a cash or in-kind transfer was probably in excess of 45 percent by 1978.

[2]The federal government's official measure of poverty provides a set of income cutoffs adjusted for family size, age and sex of family head, number of children under age 18, and farm-nonfarm residence. The cutoffs provide an absolute measure of poverty which specifies in dollar terms minimally decent levels of consumption for households of different types. The cutoffs are adjusted each year by the change in the cost

of living. For 1978, the poverty lines range from $2,650 for a single, aged female living on a farm to $11,038 for a two-parent family of seven or more persons not living on a farm. The average threshold for a family of four for 1978 is $6,628. Poverty incidence as measured in this paper uses the household as the unit of analysis.

Households in which the head is reported as married, but the spouse is absent, are counted as two-parent households. For an analysis of the trend in poverty among persons, see Danziger and Plotnick (1980).

[3]The decline in the incidence is computed by subtracting the 1978 incidence from the 1965 incidence, dividing by the 1965 incidence, and multiplying by 100. For example, (14.3 - 13.2/14.3) x 100 = 7.7 percent.

[4]As mentioned above, the data presented here do not include in-kind transfers. However, Smeeding (1982) finds that about 20 percent of female-headed households are poor even if in-kind transfers (including Medicaid) are valued as equivalent to cash income.

[5]The pattern of results is the same when region, or education, or age of the head of household is varied. More detailed results are available from the author. The predicted incidences show less variation across the races than the actual data because they control for personal characteristics. For example, the differences by races in Table 2 are for households with the same education, while the actual education of white household heads is higher than that of the other groups. Thus, the actual differences in poverty can be decomposed into a component due to differential probabilities, holding characteristics constant, and a component due to differing characteristics.

[6]For example, the aggregate decline in the incidence, 6.1 percent, shown in figures 3 and 4 (from 45.6 to 42.8 percent), was smaller than the decline for either divorced, separated, or widowed heads (13.6 percent, from 43.3 to 37.4 percent) or never-married heads (6.3 percent, from 70.4 to 66.0 percent) because of the more rapid growth of never-married heads.

[7]The work lost because of the increased disincentives for those who continue to receive welfare may be partly offset by increased work from those whose eligibility is terminated. These former recipients no longer face any benefit reduction rates, and they will probably be eligible for the Earned Income Tax Credit, discussed in the next section, which partially offsets payroll and personal income taxes. The Reagan program also seeks to offset the increased work disincentives for welfare recipients by enforcing work requirements.

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Have We Already Lost the "War on Poverty?"

Peter T. Gottschalk

Project Associate
Institute for Research on Poverty
University of Wisconsin, Madison
and
Assistant Professor
Bowdoin College, Brunswick, Maine

During the mid-1970s two interrelated trends were widely recognized both in the press and in the professional literature: (1) The proportion of people with total incomes below the poverty line had dropped dramatically during the 1960s and early 1970s. As column 1 of table 1 shows the incidence of post-transfer poverty had dropped from 17.3% in 1965 to 11.2% in 1974. (2) The U.S. was devoting an increasingly large proportion of its national income to income transfers, aimed at raising the incomes of those at the bottom of the distribution. Columns 3 and 4 of table 1 show that both total transfers and income-tested cash transfers grew faster than national income. This "welfare explosion" was even larger when one includes expenditures on Food Stamps (column (5)).

The drop in poverty was not unrelated to the growth in transfers. As more people received benefits, their total incomes grew. Many were raised above the poverty line, not through improved labor market conditions, but through increased transfers. This is documented in column 2 of table 1 which shows that the proportion of households with low earnings actually increased from a low of 27% in 1968 to 30.4% in 1974. The drop in earnings was, however, offset by the increased transfers, resulting in a decrease in the proportion of people with total incomes (which includes transfers as well as earnings) below the poverty line.

From these facts economists deduced that there were three important macro factors which affected poverty: secular growth in transfers, secular growth in the proportion of people with low earnings and cyclical changes in both earnings and transfers. During the early 1970s two of these three factors (secular growth in transfers and improved cyclical conditions) were sufficiently strong to overcome the secular rise in the proportion of people with low earnings. The result was the large drop in post-transfer poverty.

It is widely recognized that the late 1970s were a period of rising unemployment. This by itself tended to increase poverty. Much less widely recognized, but equally important, is the fact that, starting in 1976, the growth in real transfers slowed substantially. Contrary to the myth that welfare programs continued to grow faster than personal income, columns 3 to 5 show that transfers as a proportion of national income declined steadily between 1975 and 1980. This secular decline in the share of national income going to welfare expenditures is apparent even if one includes expenditures on Food Stamps, an important in-kind program for the poor. These figures tell us that the <u>"welfare explosion" was contained well before the budget cuts of 1981</u>.

Given our understanding of the relationship between reduction in poverty and the growth in welfare, it should not be surprising to find that as the growth in cash transfers declined, poverty increased. The size of the increase may, however, be surprising to some people.

While post-transfer poverty dropped at an annual rate of 6.5% between 1965 and 1976, it actually increased at a 2.4% rate between 1976 and 1980. By 1980 poverty was above its 1967 level.

I project that when people are surveyed in March of 1982 (to find the proportion with low incomes in 1981) we will find that 13.7% of the population was poor in 1981. Part of this rise is due to the recession. However, even if we had maintained the relatively low unemployment rates of 1979 (5.8%) I estimate that poverty would have been 12.6% and 13.1% in 1980 and 1981, respectively. Therefore, the erosion of almost 15 years of progress cannot be blamed solely on cyclical conditions.

Neither can it be attributed to Reagan's cuts in real transfer expenditures. The decline in transfers started in 1976, well before the budgetary cuts of 1981. We have not only started to dismantle the apparatus which gave low income people money, we have already achieved a substantial reduction in the size of those programs. By 1980 we were spending the same proportion of national income on "welfare" as we were spending a decade earlier. The only transfer programs which did not seem to suffer the same amount of retrenchment were the social insurance programs aimed at the elderly (e.g., Social Security).

The future does not look bright. As the unemployment rates rise and Reagan cuts in social programs are translated into reductions in cash transfers to the poor we can expect poverty to continue to increase. Assuming that unemployment will rise to 8.5% and the constant dollar expenditure on transfers will decline by 5% we can expect poverty rates to exceed 15% by 1982. Even under the rosy scenario that supply side policies will bring unemployment rates down in the long run, poverty rates will still be historically high. Assuming an unemployment rate of 5.5% and a 15% drop in real transfers, the poverty rate in 1984 will be higher than it was 17 years earlier, at the start of the War on Poverty.

If we have not already totally lost the ground won during the "War on Poverty" it seems very likely that any remaining gains will be lost in the next few years.

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Table 1

Poverty Rates and Transfers 1965 to 1981

	(1)	(2)	(3)	(4)	(5)
	Incidence of		Transfers as Percent of National Income		
				Income-Tested Transfers	
	Post Transfer[1] Poverty	Earnings[2] Poverty	Total Cash Transfers	Cash	Cash & Food Stamps
1965	17.3	.299	6.5	.71	.71
66	14.7	.278	6.3	.69	.69
67	12.8	.271	6.5	.75	.75
68	12.1	.270	6.8	.79	.79
69	12.6	.271	6.0	.89	.89
70	12.5	.283	8.1	1.11	1.18
71	11.9	.294	8.9	1.26	1.44
72	11.1	.292	8.8	1.16	1.36
73	11.6	.292	9.0	1.07	1.28
74	11.2	.304	9.9	1.24	1.49
75	12.3	.318	11.5	1.34	1.73
76	11.8	na	11.2	1.29	1.71
77	11.6	na	10.7	1.10	1.55
78	11.4	na	10.1	1.08	1.38
79	11.6	na	10.1	1.02	1.36
80	13.0	na	11.0	1.05	-
81	13.7 (est)	.317 (est)	-	-	-

Source: Col. (1) Gottschalk (1981) for 1965-75.
Col. (2) Current Population Report Series P-60
Col. (3),(4) and (5), Tables M-1 and M-39 Social Security Bulletin, December 1981 and January 1976. Table 1 Skolnik (1977) and Bixby (1981).

[1]Percent of persons in households with total cash incomes below poverty line.

[2]Percent of households with earnings below poverty line.

Representative REUSS. Thank you, Mr. Danziger. Mr. Rousseas.

STATEMENT OF STEPHEN ROUSSEAS, DEXTER M. FERRY, JR., PROFESSOR OF ECONOMICS, VASSAR COLLEGE

Mr. ROUSSEAS. Well, Professors Budd and Danziger have given some very valuable testimony, and I'd like to restrict myself to a general overview of things as I see them.

Representative REUSS. Mr. Rousseas, may I say your excellent piece in Challenge magazine and your earlier piece in the Journal of Post Keynesian Economics are incorporated in full into the record, and are very valuable.

Mr. ROUSSEAS. Thank you. It has become very fashionable to blame the problems of the present on the policies of the past. I found this a gross rewriting of history, and it is to this issue that I will address my remarks.

In today's "Washington Post," I read of the President's speech in Indianapolis yesterday, in which he said, "We have in place an economic program that is based on sound economic theory. We have faith in our program, and we are sticking with it."

THE SUCCESSFUL RECORD OF POSTWAR ECONOMIC POLICIES ON EQUALITY * * *

I consider this to be a tragedy for the country. What we are faced with is a counterrevolution of the first order, a counterrevolution based on ideologically slanted theories which simply do not hold up to careful scrutiny and which threaten to destabilize the country by polarizing it. Throughout the postwar period, Republican, as well as Democratic, administrations supported and furthered social policies that led to a marked improvement in the distribution of income as compared to the predepression era of the 1920's. This was largely accomplished by a marked increase in government transfer payments. At the same time, succeeding administrations to a greater or lesser degree followed countercyclical fiscal and monetary policies.

The compensatory role of government served to diminish markedly the prewar gyrations of the economy which culminated in the Great Depression of the 1930's. The postwar experience, so far has been limited to short-lived, relatively mild recessions. Where expansions averaged 26 months and contractions 21 months from 1854 to 1937, postwar expansions have had an average duration of 48 months with contractions compressed to an average of 11 months.

The success of the postwar economic policy was to be measured, according to the late Arthur Okun, "not in dollars of real GNP, but in the survival of U.S. capitalism"—largely because of the economic policies of the Federal Government.

To summarize, as Alan Blinder has pointed out, the transfer payments were clearly responsible, in great part, for the improvement of postwar distribution of income, for its relative constancy over the past 35 years, and for the amelioration of poverty. In conjunction with the macroeconomic policies of the Government, they also contributed to the greater stability of the postwar economy.

I would like to emphasize that it was the redistributive and stabilizing activities of successive postwar governments that played a positive role in the postwar performance of the American economy. What we have to keep in mind above all is that income is a flow dependent upon a stock of wealth. What evidence we have indicates that the stock of wealth, although more unevenly distributed than the flow of income, has also been relatively stable in the postwar period with no trend discernable. It should be obvious that an increase in the inequality of wealth would have a marked impact on the distribution of income, particularly, if Government tax and expenditure policies are changed drastically to favor the accumulation of wealth by the already wealthy, which brings me to the supply side policies of the current administration.

* * * AND THE HARM THAT WILL BE DONE BY REAGANOMICS

I don't think I have to describe to this committee the details of the 1981 tax and Government expenditure cuts. Their impact on the distribution of income and wealth is obvious. Social transfer payments have been slashed, to be followed now by a second round of cuts. I have before me a table put out by the New York State Office of Federal Affairs, which points out that in real terms, that is adjusted for inflation, CETA employment and training from 1981 to 1983 will be cut by 84 percent, child welfare block grants by 42 percent, community health block grants by 36 percent, urban development action grants by 49 percent, mass transit operations 44-percent reduction, mass transit capital, 43 percent. And as an educator, this is the most appalling of all to me, elementary and secondary education is to be cut in real terms by 67 percent and vocational adult education by 50 percent.

Their impact on the distributions of income and wealth, as I said, is obvious. If we look at the tax cut, the 25-percent cut in taxes to be phased in over a 3-year period, it's only a part of the overall picture. As David Stockman himself has admitted, the top marginal tax rate on investment income, that is interest, dividend and rents, was cut from 70 to 50 percent, effective January 1, 1982, with capital gains for those in the higher tax brackets falling from 28 to 20 percent retroactive to June 1981.

If you add to this the effectual abolishment of inheritance taxes, it is clear that the biggest tax cut is going to the rich. And if the pressure of over $100 billion deficits into the mid-1980's, at least, builds up sufficiently, to stretch out or postpone the tax cuts on earned income, the redistributive effects will be larger still.

On top of all this, we now have the New Federalism, which will either force the States to increase their taxes by 9 percent on the average—along regressive lines, I might point out—or cut back on essential social services. The chances are overwhelming that they will do both. All this is based, to put it bluntly, on what I regard as a hairbrained, insensitive theory which says that it is because of a poverty of wealth, in the sense that the rich are prevented by the Government from being richer still, that the poor are poorer than need be, or as John Kenneth Galbraith has felicitously put it, "The poor won't work because they have too much money, and the rich won't work because they have too little." Therefore, according to supply side theory, all we have to do is redistribute wealth in favor of the productive rich, in order for everyone, including the poor, to be better off. I find this approach patently absurd. More than that, it threatens the very stability of our society.

We are now in the midst of a crisis of faith, and I have submitted to the committee a longer version, entitled "The Crisis of Faith," where I argue in more detail, it is in times such as these that the new breed of ideological visionaries emerges, which is prepared to sacrifice the present and the past in the name of a utopian future, even if it means an increase in human suffering and the sacrifice of the powerless and the disenfranchised on the way to that good society. Chiliasts have a longrun view. They are not known for their tolerance or forebearance in the short run or for their sensitivity to human suffering. Supply side theory is a repudiation of the past, a desperate attempt to undo the last 50 years and return to the prewar world of the 1920's.

Modern post-industrial capitalism has survived as long as it has because of one unique aspect in its historical development: its flexibility and its ability to respond to changed circumstances and needs. It has been this enormous elasticity of capitalism in a democratic context that has confounded Marxian analyses of capitalism's imminent demise. It is this flexibility we are losing. It is the policies of the current administration that may well blow things apart. If we want to see where we might be going, it behooves all of us to reread the Kerner Commission Report. The system is being rapidly deligitimated.

THREE SCHOOLS OF REAGAN ECONOMISTS CLASH ON ADVICE

I would like to close by referring to the article I have submitted to the committee. I have made up a table, almost with tongue in cheek, showing the flow of Reagonomics. It is not a consistent theory. What we have is three distinct groups within this—under this rubric of economics. We have the "Old Guard Informal Advisory Council," consisting of Arthur F. Burns, Alan Greenspan, and George Schultz. We also have what I called "Classical Supply-Side Theory," with Jack Kemp and then, of course, Arthur Laffer, Jude Wanniski and George Gilder.

And then we have a third group. It is what I call "Neoclassical Supply-Side Theory," which is more of a monetarist camp. And I want to close by having something to say on this, and of course, this is largely the Treasury. Under Donald Regan, you have Norman Ture and Beryl Sprinkel.

So what I'm trying to say is that Reaganomics is a general term covering basically three loosely aligned groups, each with its own particular viewpoint. The only thing that unites them is a shared aversion to the liberal policies of the postwar period. Each gives conflicting advice to the President and each jockeys with the others in the corridors of power. A corporate organization chart that I've just referred to shows that the President's Advisory Council is simply for cutting government expenditures and balancing the budget. The classical supply-side school under the putative leadership of Congressman Jack Kemp, but dominated by two former Wall Street Journal writers and the authors of two basic books on supply-side economics, believe that tax cuts are all, and deficits which unbalance the budget are, of secondary importance.

Finally, neoclassical—the neoclassical monetarist school is to be found in the Treasury Department. They are largely of the Chicago school and followers of Milton Friedman who, I might add, is not very popular with what I call the classical supply-side theorists. For the classical school, tax cuts are everything and monetarism is either dismissed as misguided or relegated to a secondary position.

For the neoclassical school, control of the money supply is the key to all problems, and for the Advisory Council, the Federal budget must be balanced at all costs.

It is not possible to predict which of the three will ultimately dominate. The chances are that Reaganomics will ignore the contradictions and borrow from all three simultaneously in various combinations, depending on which way the political winds are blowing.

And I want to conclude, finally, by referring particularly to the Treasury component of supply-side economics. What we are told first is that interest rates are largely a function of the price level, or rather inflation and the growth of the price level. We're also told on the basis of quantity theory of money, that the price level depends on and is a function of the growth rate of the money supply. If that is so, it follows that interest rates also depend on the growth rate of the money supply. The remarkable thing about this is that we are told that the interest rate and the money supply are positively related.

What do I mean by that? We have the most remarkable proposition that easy money leads to high interest rates and tight money leads to low interest rates. We are also told that wages depend on the rate of inflation. Consequently wages are also dependent upon the growth of the money supply.

What I'm trying to indicate here is that this entire theory essentially is based on a theology. It's based on the belief that inflation is a function of the growth rate in the money supply. That is some version of the quantity theory of money. If that is not so, then we're paying a terrible price for what is happening.

I would identify myself as a post-Keynesian, where I believe that the money supply is essentially endogenous and passively accommodates the needs of the economy, and that prices, if anything, are a function of unit labor costs, and if we are to deal with the problem of inflation, indeed, it must be on the basis of some incomes policy, such as TIP. And to base ourselves on the monetarist version of supply side, I think, is a disaster for this country. Thank you.

[The prepared statement of Mr. Rousseas, together with the articles referred to, follows:]

PREPARED STATEMENT OF STEPHEN ROUSSEAS

I received the written invitation to appear before this Committee, the mail being what it is, on Monday -- which left me little time to prepare a detailed statement on the concerns of the Committee regarding the effect of the Reagan Administration's economic policies on the distributions of income and wealth. I have already submitted to the Committee's Staff copies of my Challenge Magazine (January 1982) article on this subject, as well as a copy of my article on classical supply-side economics which appeared in the recent Winter 1981-82 issue of the Journal of Post Keynesian Economics. I would also like to submit for the consideration of this Committee the original and longer version of my paper, entitled "The Crisis of Faith," from which the Challenge article was taken in abbreviated form.

This material will, I think, give a more detailed outline of my views. The issues are complex and controversial and I cannot adequately cover them in the time alloted. For my oral testimony, I will therefore limit myself to a summary presentation.

What we are faced with is a counter-revolution of the first order --

a counter-revolution based on ideologically slanted theories which simply do not hold up to careful scrutiny and which threaten to destabilize the country by polarizing it. Throughout the postwar period, Republican and well as Democratic Administrations supported and furthered social policies that led to a marked improvement in the distribution of income, as compared to the pre-depression years of the 1920s. This was largely accomplished by a marked increase in government transfer payments. At the same time succeeding Administrations, to a greater or lesser degree, followed contracyclical fiscal and monetary policies. The fact is that the public debt as a proportion of GNP has not changed appreciably, and this is the important point, not how many miles high it is in absolute terms.

The compensatory role of government served to diminish markedly the prewar gyrations of the economy, which culminated in the Great Depression of the 1930s. The postwar experience, so far, has been limited to short-lived, relatively mild recessions. Where expansions averaged 26 months and contractions 21 months, from 1854 to 1937, postwar expansions have had an average duration of 48 months with contractions compressed to an average of 11 months. The success of postwar economic policy was to be measured, according to the late Arthur Okun, "not in dollars of real GNP, but in the survival of United States capitalism"-- largely because of the economic policies of the Federal government.

In summary, transfer payments were clearly responsible, in great part, for the improvement of the postwar distribution of income, for its constancy over the past 35 years, and for the amelioration of poverty, which decline by 24 percent between 1965 and 1976. In conjunction with the macroeconomic policies of the government, they also contributed to the greater stability of the postwar economy. It was the redistributive and stabilizing activities of successive postwar governments that played a positive role in the postwar performance of the American economy.

We must keep in mind, however, that income is a <u>flow</u> dependent on the <u>stock</u> of wealth. What evidence we have indicates that the stock of wealth, though more unevenly distributed than the flow of income, has also been relatively stable in the postwar period, with no trend discernable. It should be obvious that an increase in the inequality of wealth would have a marked impact on the distribution of income, particularly if government tax and expenditure policies are changed drastically to favor the accumulation of wealth by the already wealthy -- which brings me to the supply-side policies of the current administration.

I don't think I have to describe to this Committee the details of the 1981 tax and government expenditure cuts. Their impact on the distributions of income and wealth is obvious. Social transfer payments have been slashed to be followed, now, by a second round of cuts. The 25 percent cut in taxes to be phased in over a three-year period is only a part of the overall picture. The top marginal tax rate on investment income (interest, dividends, and rents) [redacted] was cut from 70 to 50 percent <u>effective January 1, 1982</u>, with capital gains for those in higher tax brackets falling from 28 to 20 percent, retroactive to June of last year. Add to this the virtual abolishment of inheritance taxes and it is clear that the biggest tax cut is going to the rich. And if the pressure of over $100 billion deficits, into the mid-1980s at least, builds up sufficiently to stretch out or postpone the tax cuts on earned income, the redistributive effects will be larger still. On top of all this, we now have the "New Federalism" which will either force the States to increase their taxes by 9 percent on the average -- along regressive lines -- or cut back on essential social services. The chances are overwhelming that they will do both.

All this is based on a hair-brained incentives theory which says that it is because of a poverty of wealth, in the sense that the rich are prevented by government from being richer still, that the poor are poorer than need be. Or, as John Kenneth Galbraith has felicitously put it, the poor won't work because they have too much money and the rich won't work because they have too little. Therefore, according to supply-side theory, all we have to do is redistribute wealth in favor of the productive rich in order for everyone, including the poor, to be better off. I find this approach patently absurd. More than that, it threatens the very stability of our society.

We are now in the midst of a new crisis of faith. It is in times such as these that a new breed of ideological visionaries emerges which is prepared to sacrifice the present and the past in the name of a Utopian future -- even if it means an increase in human suffering and the sacrifice of the powerless and the disenfranchised on the way to that good society. Chiliasts have a long-run view. They are not known for their tolerance and forebearance in the short run or for their sensitivity to human suffering. Supply-side theory is a repudiation of the past, a desperate attempt to undo the last fifty years and to return to the prewar world of the 1920s.

Modern post-industrial capitalism has survived as long as it has because of one unique aspect of its historical development: its flexibility and its ability to respond to changed circumstances. It has been this enormous elasticity of capitalism, within a democratic context, that has confounded Marxian analyses of capitalism's imminent demise. It is this flexibility we are losing. It is the policies of the current administration that may well blow things apart. If we want to see where we might be going, it behooves us all to re-read the Kerner Commission Report. The system is being rapidly deligitimated.

RETURN OF THE ECONOMIC ROYALISTS

STEPHEN ROUSSEAS

The economic shocks of the 1970s diminished the flexibility and growth of capitalism. The resulting crisis helped spawn a simplistic theory of taxes and human behavior—supply-side economics.

The Great Depression took place half a century ago. It was by far the greatest challenge American capitalism had had to face since the Civil War. On a black Thursday the stock market crash wiped out the paper wealth of the newly rich, and massive bank failures cleaned out the life savings of many of the not-so-rich. Real output fell by one-third, factories closed, and unemployment soared to 25 percent of the labor force. According to the conventional economic theory of the time, it could not and should not have happened.

True, panics and cycles were a part of our past, but they were fleeting incidents in a rapidly growing, exuberant economy engaged in the heady process of creative destruction. Cycles were seen as an unavoidable part of capitalism (attributed by some to sun spots) to be borne in stoic silence. There could therefore be no moral responsibility for the short-run suffering of the mass of people, and if the poor suffered unduly, it was because of their failure to limit their daily consumption in good times so that they could provide for the inevitable rainy days. For others, cycles were purely monetary problems which the creation of the Federal Reserve System in 1913 had solved once and for all. In the 1920s, American capitalism was seen by the economics profession as marching forward resolutely on a plateau of infinite prosperity.

Then came the collapse. One of the great axioms of our existence is: *what is, is possible*. The Great Depression was there in all its black majesty and it was not just another rainy day; it was a storm that threatened the very survival of the system. And there was no new theory to provide a quick fix; Keynes's *General Theory* came later. The political response in the United States was purely pragmatic, a groping for solutions that led to that amalgam of policies called the New Deal. Its public work projects, its relief for the poor, its civilian conservation program for unemployed youth, the National Recovery Act (NRA), and the establishment of a social security system—all these gave some measure of hope to a dispirited nation. Yet, in retrospect, the New Deal did too little rather than too much. The U.S. economy began its full recovery only with the 1939 onset of World War II in Europe, and with its own direct involvement in 1941.

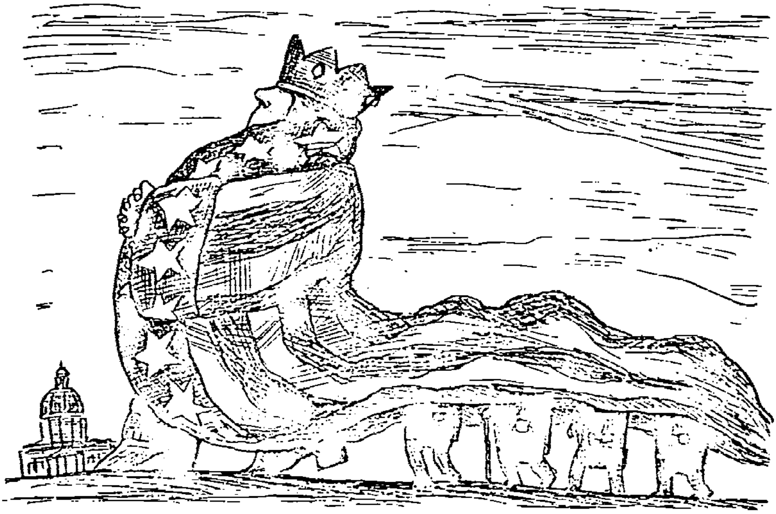
As World War II was coming to an end and victory was assured, the old fears emerged. The National Planning Association was established in Wash-

STEPHEN ROUSSEAS is Dexter M. Ferry, Jr., Professor of Economics at Vassar College. This article is adapted from his paper at the Third Annual Sewanee Economics Symposium on "Perspectives on the Stagflation Economy," University of the South, October 1981.

ington and quickly recruited a staff of professional economists to work on a national plan for the postwar reconversion of the economy. The British White Paper of 1945, for the first time in modern history, proclaimed the government's responsibility to provide for *full* employment in the postwar world, and in the United States the Employment Act of 1946 committed the federal government to the maintenance of *maximum* employment, the concept of full employment being too controversial for the U.S. Congress. Governments were to be clearly responsible for the overall performance of their economies by adopting appropriately stabilizing fiscal measures. And it was on this basis that we entered the postwar period with some trepidation but armed with a new theory for managing aggregate demand. Government was to compensate for the occasional market failings of the capitalist system, with special emphasis on the "free" market's failure to provide for full employment.

Assessments, pro and con

On the occasion of its one hundredth anniversary in 1980, the National Bureau of Economic Research (NBER) held a conference on *The American Economy in Transition*. Its participants were asked to review the overall postwar performance of the American economy from the point of view of their specialties. 1980 was not a good year. The economy was once again in serious trouble. Martin Feldstein, a leader of the current counterrevolution and host of the Conference as director of the NBER (also editor of the book emerging from the conference), attributed the poor performance of the American economy to government interference. The worm had turned. "There can be no doubt," he wrote in *The American Economy in Transition* (University of Chicago Press, 1980), "that government policies . . . deserve substantial blame for [our] adverse experience." (p. 3) Government regulations, income transfer and social insurance programs, and the inhibiting tax effects on capital accumulation, had sapped the vitality of capitalism. Feldstein's views, however, were hardly reflected in the papers of his main participants. Instead of a return to "the years of chaos and depression," the postwar economy, according to Benjamin Friedman, "entered an era of stability and prosperity" with not only a higher average growth rate in



the postwar years "but also a smaller variability of that growth." (pp. 11-13) The "categorical imperative" of postwar policy-makers, in the opinion of the late Arthur Okun, was the avoidance of the Great Depression, and in that they largely succeeded. The business cycle had been tamed—or at least brought within politically tolerable limits. This newfound stability, moreover, was greater than it had been at any other time. Where, from 1854 to 1937, expansions averaged 26 months and contractions 21 months, the postwar expansions had an average

". . . the United States continues to have greater inequality in income distribution than many other industrialized countries. . . ."

duration of 48 months with contractions compressed to an average of 11 months. "This quantum jump in stability," argued Okun, "must . . . be credited to public policy. *"It was made in Washington"* (italics mine) and it was "the compositional shift" to a larger public sector GNP share that constituted "the largest single stabilizing element." The American economy's sensitivity to cyclical fluctuations was markedly reduced. In this context, the growth of government transfer payments was a critical development. To Okun, the success of postwar economic policy was to be measured *"not in dollars of real GNP, but in the survival of United States capitalism."* (pp. 162-63, italics mine)

Okun's assessment of the postwar performance of the U.S. economy is amply reinforced in Alan S. Blinder's analysis of the postwar distribution of income. Although there was little change in the postwar distribution of income, it was "noticeably more equal than the distribution of 1929." (p. 435) Despite this improvement, however, the United States continues to have greater inequality in income distribution than many other industrialized countries. In 1977, according to Blinder, "the richest fifth of American families received eight times as much income as the poorest fifth." (p. 436) To Blinder, this constant 8:1 postwar ratio, though better than that in the prewar period, is nevertheless "a very substantial income gap."

The constancy of the postwar income distribution is in large part due to government transfer payments—both in kind and in cash, with the latter playing a more significant role. Transfer payments as a proportion of GNP rose from 0.7 percent in the 1920s to more than 10 percent for 1973-79. To Robert Gordon "the growth in the size of government after 1947 was mainly reflected in transfer payments rather than in goods and services." (p. 110) The combined spending on goods and services by federal, state, and local governments as a percentage of GNP "exhibited no increase at all between the 1957-67 decade and the most recent 1973-79 subperiod." The increase in the size of government in the postwar economy must therefore be attributed to transfer payments—which served the dual function of preventing a deterioration in the distribution of income in the postwar period while simultaneously adding to the stability of the postwar economy. Since "the lower income strata receive a disproportionately large share of transfers," according to Blinder, "it is clear that cash transfers pushed the distribution of income in the direction of greater equality during the postwar period." (p. 446)

What about poverty?

But what of the problem of poverty in the postwar era? Whether using the official "absolute" standard of poverty (based on a basket of goods adjusted for inflation) or a "relative" standard of poverty (those with incomes 44 percent below the median income, for example), Blinder finds that *when transfers are deducted from income*, poverty goes up from 11.8 to 21 percent on the absolute standard and from 15.4 to 24.1 percent on the relative standard. Government transfer payments must therefore also be seen as a critical factor in the amelioration of poverty.

In the postwar period, there was a marked decline in officially defined poverty during the 1960s, largely because of the War on Poverty programs of the Johnson administration. In summary, transfer payments are clearly responsible, in great part, for the improvement of the postwar distribution of income over its *prewar* distribution, for its constancy over the past 35 years, and for the amelioration of poverty. In conjunction with macroeconomic policies, they also contributed to the greater stability of the postwar economy. In short, the *redistributive and stabilizing* activities of the government have played a positive role in the postwar performance of the American economy—with the redistributive impact largely the result of "the rapid growth of cash transfers [and] . . . the War on Poverty. . . , [as well as] on the equally rapid growth of transfers in kind, . . . [and] other programs such as affirmative action guidelines, equal opportunity and antidiscrimination laws." (Blinder, p. 473)

However well we may have done in improving the distribution of income and preventing its deterioration over the postwar years, the fact remains that income is a *flow* dependent on the *stock* of wealth. What of the distribution of wealth in the United States, about which we know considerably less? The available evidence seems to indicate that wealth inequality is greater than income inequality, and that it is relatively stable with no trend discernible. It should be obvious that an increase in the inequality of wealth would have a marked impact on the distribution of income, particularly if government tax policies were drastically changed to favor the accumulation of wealth and even more so if, at the same time, the welfare aspects of government transfer payments were subject to substantial cuts—a point that will be reinforced in my discussion of the supply-side economic policies of the Reagan administration.

The elasticity of capitalism

Modern post-industrial capitalism has survived as long as it has because of a unique aspect of its historical development: its flexibility and its ability to respond to changed circumstances. Unlike the regimes of the Bourbons and the Romanoffs, capitalism has been able to defuse potentially threatening situations and to adapt to changing circumstances along lines that assure its continuation. It has been this enormous elasticity of capitalism, within a relatively democratic context, that has confounded Marxian analyses of its "internal contradictions" which, according to a mechanical dialectic, guaranteed its demise in a bloody collapse. It has been capitalism's ability to place "an iron bit in nature's mouth" that has enabled it to co-opt its opponents through higher and higher levels of real income. The key has been in a virtually limitless accumulation of capital and the growth that goes along with it. And it is growth that has served, up to now, to legitimate the capitalist system and modify inequalities in the distribution of income and wealth that would otherwise have been politically destabilizing. As long as growth and capital accumulation continue, distribution is not a political problem: the system is seen and accepted as just. It is only when growth becomes problematical that the legitimacy of capitalism is cast in doubt and distribution becomes a political issue.

". . . wealth inequality is greater than income inequality, and . . . it is relatively stable with no trend discernible."

This is exactly what happened in the 1930s. The economic crisis was transformed into a social and political crisis with a resurgence of class antagonism, such as Britain is now experiencing in the wake of Margaret Thatcher's policies. The problem in the 1930s was that investment was largely a private matter in which the state had no direct role to play. The government's response to the Great Depression was to try to influence investment decisions—indirectly by encouraging consumer spending via personal income tax changes and transfer payments, and directly, by trying to organize businesses into huge cartels under the NRA and by outright grants and subsidies to business via the Reconstruction Finance Corporation (RFC). The postwar growth of government was the result of these policies, with cuts in corporate income taxes, investment tax credits, and accelerated depreciation constituting the modern and softer variations on the New Deal theme.

From the late 1950s up to the U.S. involvement in the Vietnam War, the postwar performance of the economy was, as we have seen, largely successful—in comparison to the trauma of the 1930s. The business cycle was still with us, but brief recessions were now followed by larger expansions. The cycle had been tamed, so much so that liberals were quite satisfied with themselves. Political sociologists, such as Seymour Martin Lipset and Daniel Bell, seconded by John Fitzgerald Kennedy in his famous Yale speech, loudly proclaimed "the end of ideology" and the historian Arthur Schlesinger, Jr. wrote an article for the *New York Times* Sunday Magazine Section (August 4, 1957) asking: "Where Does the Liberal Go From Here?"

Schlesinger described the two sources of liberalism as "the vindication of the individual against economic privation and despair, [and] the vindication of the individual against moral and spiritual frustration." He then went on to state that the first vindication had been largely achieved in the postwar period by "the most brilliant explosion of creative social thought this country has ever seen." He was convinced that modern mixed capitalism had solved its major economic problems. All that remained was a minor cleaning up operation.

Having solved virtually all of our economic problems stemming from the 1930s, what we now needed was a "new" liberalism which would "recover [its] deeper roots in the American cultural tradition [by shifting its] focus from economics and politics to the general style and quality of our civilization." Creative spontaneity could now be let loose in an economically secure world. The problem was no longer economic unemployment but "spiritual unemployment." What this new breed of liberals had to do was "to help prime the pump, not economically, but ethically." Too early for Schlesinger's metaphysics to have been set in motion, one defeated Democrat in the elections of 1952 was heard to lament, "The trouble is, we ran out of poor people."

A big exception, the 1970s

To a large extent, this celebration of the status quo is reflected in the centenary celebration of the NBER, except for one troubling development: the 1970s. The consensus politics of the 1950s and early 1960s began unraveling with the inflationary guns *and* butter policies of the Johnson administration. Then came a series of supply shocks that made a shambles of the fine-tuning nostrums of orthodox, neoclassical Keynesians as well as the steady-as-you-go monetary growth rule of the monetarists. Inflation was now linked with a chronic level of unemployment that made "stagflation" the faddish neologism of its time. The supply shocks started with the worldwide crop failures of 1972, quickly followed by the devastating 1973 OPEC crisis which had a shattering effect on growth and led to a rapid acceleration of the inflation rate. Lower levels of GNP were now associated with still higher price levels. These supply shocks were an addition to the inflationary bias built into the economy by the successful postwar stabilizing policies of the government. The underlying inflation rate of about 5 percent in the 1960s was, in retrospect, politically tolerable. Building on this basic inflation rate, the supply shocks pushed the economy into double-digit inflation at the same time as employment and economic growth were seriously depressed.

It is invariably during periods of great crisis, when conventional theoretical explanations no longer serve their legitimating roles, that the groundwork is laid for the rise of crackpots and assorted runaway ideologues with simple explanations for complex problems, designed explicitly for simple minds. This is the stuff of manipulated mass movements, particularly of a counterrevolutionary bent. Generally, all of society's ills are attributed to a single cause. And for single causes there are single solutions—panaceas for piping us into the good society. It was the 1970s, and the inability of existing theories to cope with dramatic, unexpected, and highly unpredictable changes in the underlying structures of society that gave rise to the ideology of supply-side economics.

Separation of theory and practice

The theory and praxis of supply-side economics are in different hands. The two major popularizers of the theory are Jude Wanniski and George Gilder. (I have treated the Wanniski-Gilder theory of supply-side economics more fully in a review article, "The Poverty of Wealth," for the *Journal of Post Keynesian Economics*, Winter 1981-82.) The main practitioners are Ronald Reagan and his now troubled Director of the Office of Management and Budget, David Stockman. Supply-side theory idealizes a past that never was or, what amounts to the same thing, it forces past history into its ideological mold. It is the world, writ large, of Andrew Mellon, Warren G. Harding, Calvin Coolidge, Ludwig Erhard and—a great hero of supply-siders—John Fitzgerald Kennedy.

Supply-side economics abhors the welfare state.

"Supply-side theory suffers from an acute case of tax fetishism. Tax cuts have become an object of irrational reverence."

Indeed, it attributes all of our current ills to a misguided and overly compassionate state. It wants to go back to the *prewar* period of an unfettered and unencumbered capitalism, to a time before the onset of postwar social policy. Its program is to undo and repeal the last half-century. It is a legitimation crisis in the making.

Essentially, supply-side economics is a theory of growth, taxation, and fiscal policy—all wedded to an old and largely discredited theory of human motivation and behavior which, if realized on *its terms*, would render moot the divisive problem of redistribution. Underlying almost all of supply-side theory is the Laffer curve, a distended belly framed by tax rates on the vertical axis and total tax revenues on the other. On its upper, negatively sloped reaches, a *cut* in the tax rate results in a more than proportionate increase in taxable income and hence in a *rise* in total tax revenue. On the positively sloped portion, the effect of a *rise* in the tax rate also yields an increase in total tax revenue because of a less than proportionate decrease (if at all) in taxable income. If we keep cutting the tax rate on the upper portion of the Laffer curve and raising it on the lower portion, we will eventually reach that optimal, or ideal, tax rate where total tax revenue is at a maximum. There are, moreover, by the very nature of the Laffer curve, two rates of taxation that produce the *same* revenue. Supply-siders are convinced, on the basis of scanty and contrived "historical" evidence, that the American economy is already on the upper portion of the Laffer curve. Hence, a reduction in the tax rate will produce an increase in government tax revenue. That is what the curve says, but it is the explanation of this putative phenomenon that yields an insight into the heart of supply-side theory. Part of the explanation of this inverse relationship between tax rates and tax revenues lies in the effect of high marginal tax rates on the underground economy. At high tax rates more and more people slip "underground." Lower the tax rate and the process reverses itself. With more and more people reentering the visible, tax-paying economy, government revenues will rise. But apart from this effect, lower tax rates increase output and hence revenues by an *incentive effect*. And it is right here that a very convenient theory of human behavior comes into full view.

Taxes and human behavior

Human beings, we are told, are hypersensitive to tax rates, especially at the margin —so much so that their behavior is obsessively dominated by them. And since economic growth is the result of human behavior and the psychological laws that govern it, it is *uniquely* dependent on the level of the marginal tax rate. A neoclassical labor market humming along under Keynes's Postulates I and II is assumed, with after-tax income substituted for the real wage rate. All unemployment is voluntary, there being no such thing as involuntary unemployment. The government with its taxing power serves as a "wedge" between what a worker gets and what he is paid. The greater that wedge, the lower the after-tax income of the individual and the less he is willing to expend effort in work. It follows, therefore, that if the government wedge is reduced, the incentive to work will soar, leading to such a disproportionate increase in output that tax revenues will actually rise in the face of a tax cut. The theory postulates a remarkably powerful relationship between work effort and taxes—and a highly doubtful one at that, even for David Stockman.

But there is more to this than first appears. Not all people are equally sensitive to the incentive effect of taxes. The higher one's income, the greater one's sensitivity. And in supply-side theory, those who earn more are more productive. More than that, they are the cutting edge of capitalism. It is the rich, as owners and creators of the physical means of production, who take the risks in an uncertain world. It is they who save and invest and make capitalist growth possible. It is they who are the legitimators of capitalism by providing for the poor through growth. Sap the energies of the rich and the system founders in an orgy of welfare programs. When the capitalist elite are demoralized, it is the poor who suffer most, and nothing demoralizes the rich more than high marginal tax rates, the proceeds of which are used to finance the welfare state in grandiose redistribution schemes such as those of the New Deal and the 1960s War on Poverty. These redistributive efforts, moreover, serve only to make the poor poorer as a direct result of the inevitable decline in output. To make matters worse, economic egalitarianism only serves to make the great unwashed more greedy. The nonrich are not creative, only the rich are. And it is the "experimental competition of elites" that generates the very dynamism of capitalism that causes the rising tide of growth to raise *all* ships to a higher level—to use Jack Kemp's favorite JFK metaphor. Capitalism is seen as a boiling cauldron of great convection currents where the *natural* elite rise from the bottom and the tired, worn-out elite, having done their thing, are cast down from whence they came. Social Darwinism at its best! Material progress, in Gilder's words, is "ineluctably elitist" and "procedurally undemocratic."

It follows, therefore, that coddling the poor undermines not only their incentive to work but, more importantly, that of the rich who are taxed to finance the welfare payments to the poor. In short, capitalism's go-go people are the very rich who consume only a small proportion of their income and use their savings to increase the rate of capital accumulation so vital for the legitimation of capitalism. To get America moving again requires only a tax cut skewed in favor of the rich and the powerful. Output will rise, unemployment will fall, as will the rate of inflation, and the poor will be the first to benefit, since the poor can only be helped by lifting the rate of investment which, in turn, can happen only if the inequality of the distribution of income and wealth is allowed to become greater. It is *regressive* taxes, not progressive ones, which help the poor most. And if, as supply-side economists maintain, a tax cut favoring the rich is the only way out of our current malaise, then the welfare state will have to be dismantled.

Supply-side theory suffers from an acute case of tax fetishism. Tax cuts have become an object of irrational reverence. Taxes are the cause of all our problems, and tax cuts will solve them—especially if they favor the rich. Supply-side economics is the *reductio ad absurdum* of capitalism. It is vulgar capitalism trying hard to make vulgar Marxism true. And in the hands of Ronald Reagan and those in his administration it is a counterrevolution of the first order.

The Reagan administration's *Program for Economic Recovery* (1981) is basically, with some major variations, a supply-side document. Its goal is to "rekindle . . . entrepreneurial instincts and creativity" by cutting taxes drastically. Government, at least as we have known it in the postwar years, is to be undone. Nondefense expenditures are to be slashed, particularly the transfer payments of the federal government which improved the prewar distribution of income and prevented its deterioration in the postwar period. The cuts in nondefense spending will certainly do wonders for the work incentives of the poor, according to the canons of supply-side theory. On the other hand, defense expenditures will increase *in real terms* between 1980 and 1984 by an annual average of 7 percent, compared to a nondefense spending rate of growth of 1 percent *in nominal terms*. Real nondefense spending will be 15 percent lower in 1984 than in 1980, according to the Congressional Budget Office. Clearly, the cuts in nondefense expenditures are to be used to finance the planned increases in defense expenditures, and the tax cut itself will serve as an *offset* to the inflation-induced income tax increase (bracket creep) and the scheduled rise in social security taxes. In effect, there will be no decrease in overall government spending and no net real tax cut—although there will be an enormous redistribution of the social product in favor of the rich. And the increased inequality in the distribution of wealth will no doubt have secondary effects on the distribution of income, making matters still worse—from the point of view of the postwar performance of the American economy.

Confusion on key issues

On the key issues of unemployment, inflation, stagflation, and money, supply-side economics is either simplistic or confused. Unemployment is caused by the wedge effect of high taxes on the rich, working through the incentive effect. But since high taxes also cause inflation, supply-siders have a convenient theory of stagflation as well. Cut taxes on the rich and output will rise dramatically. Unemployment will go down as a result, along with prices. In one fell swoop, we have the solution to unemployment, inflation, and stagflation. That is the simplistic side of supply-side economics. The confusion comes in through the money window. What is the role of money in the explanation of inflation? Some supply-siders, such as Gilder, have no use for Milton Friedman's monetarist explanations. Prices are a function of taxes, not the money supply—or deficits for that matter. Monetarists are closet Keynesians working the demand side of the street. Monetary restraint serves only to inhibit private sector growth, which adds to inflationary pressures. In other words, tight money's effect is on output and employment, not on prices. Moreover, along post-Keynesian lines, the money supply is *passive*. The banking principle triumphs over the currency principle in that the needs of trade take precedence, with the money supply expanding automatically (through financial innovations and jumps in the income velocity of money) in order to accommodate the higher levels of nominal GNP.

"It is only when growth becomes problematical that the legitimacy of capitalism is cast in doubt and distribution becomes a political issue."

Other supply-side theorists, like Wanniski, explain the *initial* inflationary price increases by relating them directly to money supply increases in excess of the real rate of growth—with the Laffer wedge inducing secondary price increases by way of progressive ad valorem taxes. Tax cuts *plus* tight money are therefore seen as *the* solution to stagflation. Then there is Jack Kemp (1979), who proposes the adoption of a strict gold standard as the only way of stopping inflation "dead in its tracks."

The Reagan administration favors "a predictable steady growth in the money supply" while attributing inflation to uncontrolled government spending and the crowding out of the private sector. Deficit spending is the primary cause of inflation, while easy money compounds the problem with secondary effects on the price level. By cutting taxes and holding a tight rein on money, the primary *and* secondary causes of inflation will be removed, or so the argument goes.

Bending reality

The current revolution in economic policy transcends theoretical niceties. It is prepared to bend "reality" to the needs of its beliefs, no matter how incoherent that makes its supporting theory. The role of established social theory is to legitimate whatever is, after the fact. It serves those who hold power. Revolutionary theories are oriented toward the future. They entail a vision of the good society. In those few instances when the promulgators of revolutionary theories succeed in gaining power, they are invariably corrupted by the need to consolidate that power. Praxis and theory are torn apart in the ensuing struggle. Purists demand that the revolution be realized immediately in its full dimensions. Pragmatists advise caution and the tempering of theory.

It is on the issue of deficits that supply-side economics has met its first defeat. More traditionally conservative economists, such as Arthur F. Burns, Alan Greenspan, and George P. Schultz, have not been sold on the wonders of the Laffer curve and, backed by doubts on the part of powerful members of the Senate and the House, they have pressured the Reagan administration into linking cuts in government expenditures to cuts in taxes. Deficits are to be avoided and the budget balanced by 1984—*at all costs.*

"At all costs," of course, means massive cuts in nondefense expenditures. Defense expenditures, given the Reagan administration's aggressive foreign policy, have become sacrosanct. Indeed, increases in defense expenditures are to be financed by the cuts in nondefense expenditures, and the programmed tax cuts wind up serving as an offset to scheduled increases in social security taxes and bracket creep. Moreover, the administration's projection of a balanced budget by 1984 is based on unwarranted assumptions concerning the growth of real output, the rate of inflation, and the level of future interest rates. For fiscal 1982 alone, the projected $42 billion deficit has ballooned to over $60 billion, if not $100 billion, by the latest count, and the stock market has all but collapsed along with housing and the automobile and steel industries. Supply-side theory has collided head-on with supply-side praxis. The resulting failure of supply-side economics to live up to its own expectations is causing panic in the White House and among its cohorts in the halls of Congress. The stock market and the Federal Reserve System are being set up as patsies and a second round of slashes in nondefense expenditures is in the making.

"With the unemployment rate of black youth over 50 percent and with further cuts in welfare transfer payments, the American economy is headed for a polarization of classes."

With the unemployment rate of black youth over 50 percent and with further cuts in welfare transfer payments, the American economy is headed for a polarization of classes. Should the economy falter, competition for scarce jobs among whites, blacks, and the disenfranchised will become more strident and the gains of the last twenty years will go by the board, followed by a search for scapegoats and an even more violent lurch toward the political right. American capitalism is rapidly losing its ability to adapt to changing circumstances. It is becoming more rigid. The progress made in the postwar period is being undone. The distributions of income and wealth are being deliberately made more unequal on the pretext of making everyone better off.

It is in the nature of ideological visionaries to sacrifice the present and the past in the name of a Utopian future—even if this means an increase in human suffering and the sacrifice of the powerless and the disenfranchised on the way to the "good society."

Supply-side economics

The poverty of wealth

STEPHEN ROUSSEAS

I

All too often, stupid books are written by clever men for stupid people. Among the cleverest are two: Jude Wanniski and George Gilder—two journalists, self-taught in economics, who have taken on the entire profession in its current disarray. Their books? *The Way the World Works* and *Wealth and Poverty*. Their sales? Enormous. Their pitch? Supply-side economics. Their mentors? Arthur Laffer, Robert Mundell, Ayn Rand, William F. Buckley, Jr., Irving Kristol, Fredrich von Hayek, Paul Craig Roberts, David Stockman, and (with reservations) Milton Friedman. Their disciple? Ronald Reagan.[1] Their whipping boys? John Kenneth Galbraith, Lester Thurow, and Robert Heilbroner.

Normally one does not review stupid books, no matter how clever their authors. But these two crusaders for the wealthy and apologists for the harshest and most baneful features of capitalism have captured the popular imagination and, more importantly, that of the politicians now in power. To historians of economic thought their books will seem more Bastiat than Schumpeter, more heavily larded with an overabundance of von Mises than with the mitigating penance of Knight.

The author is Dexter M. Ferry, Jr., Professor of Economics at Vassar College.

[1] When the chairman of the Senate Finance Commiteee, Robert Dole, was hospitalized shortly after the inauguration, President Reagan paid him a courtesy visit. Instead of flowers, he gave him a copy of Gilder's book. The Senator recovered.

Keynesians had to wait until the 1960s to sniff at the hems of power, only to fail in the Camelot days of JFK and Vietnam; monetarists got trapped in Goldwater's burning wagon in 1964, although later they did better in other lands with Margaret Thatcher and Augusto Pinochet; Marxism, of course, was perverted by Lenin fifty years after the fact. But supply-side economics has "hit the ground running," as that bandied Reagan camp saying goes.

"Progress," wrote George Santayana, "is relative to an ideal which reflection creates." "Change," said Bertrand Russell, "is indubitable. Progress is a matter of controversy." There is little "reflection" in supply-side economics which, I suspect, is the reason why it has been able to reduce all "controversy" to a romantic celebration of an idealized capitalism. And if "change" has been for the worse, as supply-siders are convinced, then we can progress only by going backwards—by repealing the last half-century. We can indeed go home again, we are told, to an individualized world of work, thrift, and altruistic giving by the rich in monumental acts of *noblesse oblige*.

What is supply-side economics about? It is essentially a theory of growth, taxation, and fiscal policy which, if realized on *its* terms, renders moot the divisive problem of redistribution.[2] Supply-side economics is capitalism writ large.

II

Surprisingly, supply-side economics is rather gentle on Keynesian economics, compared with its rough jostling of Friedmanian monetarism, and there is even a marked affinity with some aspects of post Keynesian economics. Supply-side economics, however, revolves around the Laffer curve. Without it, there would be little left. It is the glue that holds supply-side economics together, tenuously.

The Laffer curve is essentially an extension of Alfred Marshall's static demand curve. The area under the Marshallian demand curve represents total revenue and what happens to it as price varies. Substitute the tax rate for price on the vertical axis, and the in-

[2] The more conservative neoclassical Keynesians have already solved, to their satisfaction, the problem of growth and distribution through Golden Age models based on marginal productivity theory. Of course, they lack the ability to measure marginal productivity, magnitudes of capital, degrees of competition, and the prevision of transactors in the market.

come of individuals who pay taxes on the horizontal axis (people in the underground economy don't pay taxes), then restate the "quantity" axis in *total* revenue terms, and the Laffer curve emerges in the shape of a distended belly with the umbilicus serving as the point of maximum revenue ($e = 1$). From this pregnant curve comes the favorite litany of supply-side economics: *There are always two rates of taxation that produce the same revenue.*

This follows from the nature of the curve. What follows next is the supply-side obsession with a particular range of the Laffer curve. For any given level of revenue, the tax rate on the upper reaches of the curve represents a tax-rate elasticity of > 1. *Reduce* the tax rate and tax revenue will *increase*. Increase the tax rate and revenue will fall, in part because more people will slip into the underground economy (and conversely for a fall in the tax rate over this Laffer range). The *same* revenue level on the lower, positively sloped, total revenue curve has a tax-rate elasticity of < 1, with exactly opposite results and no underground economy to speak of. The tax rate, obviously, has a range between zero and 100 percent. At 100 percent, the argument goes, nobody would work for pay, and the government's tax take would be zero—only an underground barter economy would exist. At a zero tax rate, however, without revenues, there would be no government at all, and anarchy would reign. It would be a Rabelaisian world of *fay ce que vouldras*. We exist, therefore, somewhere between these two extremes.

The bellybutton ideal, the *optimum* where revenues are at a maximum, "is the point at which the electorate desires to be taxed" (p. 98). Reversing the axes, it is the North Pole of the Laffer curve: with any step in any direction revenues will fall. "It is," moreover, "the politician's job to find out what that [ideal] rate is" (Kemp, 1979, p. 51). It is not necessarily 50 percent, though it could be. It all depends on the sensibilities of taxpayers and the amount of government services they *wish* to have and are willing to pay for without coercion. And how are we to find this ideal tax rate? It's simple. "The easiest way for a political leader to determine whether an increase in the rates will produce increased rather than falling revenues, is by putting the proposition to the electorate" (Wanniski, p. 100). All it would take is a referendum!

There is no doubt in the minds of supply-siders that we are way beyond the optimal point on the upper reaches of the Laffer curve.[3] If so, then a tax cut will result in increased revenues,

[3] Of course, Keynesians and their first-cousin monetarists suffer from the delusion of thinking that we are on the lower, inelastic portion.

with the opposite effect for a rise. The explanation lies, apart from the underground economy effect of high taxes, in the "fact" that high taxes are associated with low levels of output, and low tax rates with high output levels—the incentive effect, as we shall see. If we are indeed on the positively sloped portion of the Laffer curve, cutting taxes will do wonders. Empirical evidence? Warren G. Harding cut taxes after World War I and the economy boomed; why it then collapsed in the 1930s is somewhat muted, although supply-side writers attribute the Great Depression *solely* to the Smoot-Hawley Tariff Act of 1930—without it things would have bounced along nicely at the lower tax rates then prevailing. Similarly for the Kennedy-Johnson tax cut of 1964 (eulogized by supply-siders) and the postwar tax cuts of Germany and Japan. Other factors that might have contributed to the postwar boom in the 1960s (the Vietnam War, for one) are blithely ignored. Seek and ye shall find. Proof consists of combing history (back to Alexander the Great) and picking out simple historical illustrations that serve your theory. Other heroes in the SS-Pantheon are Andrew Mellon, Calvin Coolidge, Ludwig Erhard, and Governor Carlos Tomero Barcelo of Puerto Rico—all true tax-cut believers, the latter having saved his commonwealth "when," according to Gilder, he "was so fortunate as to meet Arthur Laffer" in the late 1970s (p. 186).[4] My favorite quotation, however, is from quarterback Jack Kemp (p. 46). His "proof" that we are on the upper reaches of the Laffer curve is as charmingly pure as open receivers on the gridiron. "When you look around and see so much evidence of unemployment and underemployment. . . . When you see more and more people shifting out of work . . . you sense that the rates are too high, and you don't have to consult a professional economist to know that lower rates would be healthier for the economy [by increasing real output] and would be likely to produce greater revenues [as a result]." Clearly there is no such thing as involuntary unemployment.

*Post*diction in support of one's theory is easy; *pre*diction is another matter. The following quotation from Wanniski leaps off the page:

[4] Wanniski was also a consultant to Barcelo. Indeed, he tells us that *The Way the World Works* "was written as a direct result of a trip to Puerto Rico in March, 1976" (p. 291). Apparently, the 60 percent welfare and food stamp economy in Peurto Rico is a Horatio Alger story. In a private communication Sidney Weintraub points out that Peurto Rico is still an LDC surviving on welfare checks and that its industrialization came from a Peurto Rican tax *exemption* (the IRS does not apply here) and an open U.S. mainland market. If *everyone*—the full country—cut taxes in the same way, it would be a disaster for Peurto Rico. Its advantage would vanish.

> At this writing, in the autumn of 1977, Britain's conservative Party leader Margaret Thatcher is steadfastly pledging to sharply reduce the progressivity of Britain's personal tax rates as soon as her party returns to power .... *Once Britain takes this step*, the expansion of its economy will have rippling effects through Western Europe, giving courage to conservative coalitions in other capitals to follow her lead (p. 298, italics supplied).

Well, Margaret Thatcher won, and at *this* writing in the summer of 1981, the economy is in the worst state since the Great Depression, with a disastrous growth rate, unemployment at over 12 percent, and riots in the streets across the breadth of England. One historical illustration is as good as another, although I would not maintain that Margaret Thatcher disproves supply-side theory any more than I would accept that their illustrations prove it. There is an old Jewish proverb that supply-siders should take to heart: *For example is not a proof.* History is messy, refusing to yield its secrets clearly except to simple or desperate minds.

III

Supply-side economists believe that a tax cut will increase government revenues by inducing an increase in real output. Supply-side economics is, therefore, a theory of growth where growth is a unique function of the tax rate or, to be more exact, the *marginal* tax rate. The explanation of this putative relationship rests on a convenient theory of human behavior. Human beings think on the *margin*, whether consciously or not, in a highly interdependent world. Everything affects everything else in a general equilibrium model. In the immortal words of Wanniski, *"Jump up and down and the whole world shakes a bit"* (p. 19). Or, as French wit would have it: *Tout est dans tout, et réciproquement*! And the margin is the key to it all. "Very few people *think* on the margin, but everyone *acts* on the margin" (p. 44, original italics). Even children! "By the time children are three or four years old," we are told, "they have acquired such a body of information by studying tax schedules and their variables within the family that they consciously 'think on the margin'" (p. 47). And when they grow up and earn their own money, they become obsessed with marginal *tax rates*—so much so that their behavior is dominated by it. And since economic growth is the result of human behavior and the psychological laws that govern it, it is uniquely dependent on the level of the marginal tax rate. An open and shut case, for Wanniski.

To Wanniski there is physical capital and there is intellectual capital. The personal income marginal tax rates are a tax on *intellectual* capital, while the corporate income tax is a tax on profits, not on the physical capital itself. Government, in other words, has a bias against intellectual capital which affects the incentive to work. "People," says Wanniski, "work for one reason and one reason only: to maximize their welfare" (p. 71). There are, of course, certain "minimum necessities for survival—food, clothing, shelter." But after satisfying them, "the individual is free to choose between work and leisure." Given an individual's "personal assessment of what constitutes welfare," he will "work *up to that point* and then not work" (p. 71, original italics). People "only work to improve their welfare" (p. 91).

This brings up the much-touted *wedge model* of Lafferian theory. It is government, through its power to tax, that introduces a "wedge" between what one gets for working and what one is allowed to keep. Personal income and social security taxes, however, are only one part of the wedge. So are minimum wage laws, taxes on capital, tariffs, all forms of government regulation, nonwork subsidies such as welfare entitlements, and anything else that represents "government intervention in private transactions" (p. 84). But the marginal rates of the personal income tax, which ranged until recently from 14 to 70 percent, are the biggest bone of contention among Lafferite supply-siders. In Laffer's words:

> Marginal tax rates . . . stand as a wedge between what an employer pays his factors of production and what they ultimately receive in after-tax income. . . . *In order to increase total output*, policy measures must have the effect of increasing firms' demand for productive factors and *increasing the productive factors' desire to be employed*. Taxes of all sorts must be reduced. These reductions will be most effective where they lower *marginal* tax rates the most. Any reduction in marginal rates means that the employer will pay less and yet employees will receive more. Both from the employer and employee point of view *more employment will be desired and more output will be forthcoming* (Memorandum, November 1974, to the then U.S. Secretary of the Treasury William Simon, quoted in Wanniski, pp. 85-86, italics supplied).

This is a neoclassical labor market humming along under Keynes' Postulates I and II if there ever was one[5] —*one in which all unem-*

[5] With after-tax income substituted for real wages as the independent variable.

ployment is voluntary. Not to be outdone, Gilder is even more explicit. "It is marginal tax rates," he writes, "that determine the impact of a tax on motives and . . . on the willingness to go out and work" (p. 181), and these same high marginal tax rates "continuously undermine the very diligence and determination that are necessary to accomplish any useful work in the world" (p. 185).

My all-time too-good-not-to-be-quoted gem comes from Wanniski:

> [In] comes Mary S., with every intention of trying to get a job at the Metropolitan Opera, perhaps in the chorus, and to work her way to stardom [shades of *42nd Street*!]. If she can't make it in this endeavor, she will become a prostitute. Upon arriving, she learns that the government has just introduced a wedge of 33 percent at the Metropolitan Opera, and it is now more profitable to be a prostitute. Equilibrium is restored on the supply-side of this process when so many women become prostitutes, that each has to put in 33 percent more time in pursuit of business. *It is clear that an increase in the government wedge decreases the quality of opera and increases the supply of prostitutes* [6] (p. 94, italics supplied).

Still, Wanniski notwithstanding, there is some hope for Mary S. A pimp's wedge cuts wider than the government's 33 percent. But Wanniski holds out another kind of hope for poor Mary S.

> In the larger economy it is of course unlikely that Mary S., the potential opera star, is directly shifted into prostitution. Rather she shifts into a lesser occupation, becoming "underemployed" in the money economy, and the wedge shifts all other employees downward into the underemployment classes, where *at the margin* an aspiring shopperson is the one who actually goes over the edge into bartering via prostitution (pp. 94-95*n*, italics supplied).

What a pity! The margin at its malevolent worst! How much better it would be to have prostitutes capable of trilling Mozart arias on the job. Think what it could do at least for the *cultural* uplifting of a prostitute's clientelle. Clearly the margin and "the expanding wedge" are capable of all sorts of wicked things. Not even Marx could have imagined a more sordid thing to attribute to the bourgeois governments of capitalism than Wanniski.

[6] At this point Laffer's tribute to Jude Wanniski's *The Way the World Works* should be indelibly recorded: "In all honesty, I believe it is the best book on economics *ever* written" (italics supplied). George Gilder calls it "One of the great inspirational works of economic literature." George Gilder, by the way, has a Norwegian elkhound called "Laffer," whose tail faithfully reproduces the "Curve."

At this point it might be wise to turn to George Gilder's book, which one *noblesse de robe* supply-sider found "Promethean in its intellectual power and insight."[7] I found it breathless.

IV

Gilder's book is about "the high adventure and redemptive morality of capitalism." He begins by proclaiming the *Golden Rule* of capitalism: "The belief that the good fortunes of others is also finally one's own" (p. 9), particularly the "good fortune" of the upper classes who are "the cutting edge of the economy—the source of most investment" (p. 20). When the capitalist elite are demoralized, it is the poor who suffer most, and nothing demoralizes them more than high marginal tax rates whose proceeds are used to finance the welfare state in grandiose redistribution schemes—Roosevelt's New Deal and L. B. Johnson's War on Poverty being the prime examples of the compassionate heart gone wrong. Take care of the poor and the vitality is sapped out of the capitalist elite, which serves only to make the poor more hapless after the inevitable decline in output.

It is the capitalist elite, as owners of the factors of production other than labor, who are exposed to risk in an uncertain world. When they add to the stock of capital, they have no assurance of new revenue. They take the plunge on faith. They are altruistic *givers.* They *are* the supply side. They "give in order to get" without being sure of the getting. They "supply in order to demand" (p. 28).[8]

It is the welfare state operating on the demand side that cripples the supply side and results in "a sluggish and uncreative economy" (p. 29). "Egalitarianism in the economy," we are told, "tends to promote greed" in the mob. And when, in a plebiscitarian mobocracy, "mass sentiment" is allowed "to dictate to the powerful . . . , the result is a restive and alienated electorate, a failure of po-

[7] Blurb by David Stockman, Director of the Office of Management and Budget. They really do wash each other's back, these supply-siders.

[8] On reading the first draft of Chapter 4 on "The Supply Side," Gilder's wife, a Vassar graduate, cried; she couldn't understand it. Gilder tried again. She cried again. (*New York Times*, April 26, 1981.) Chapter 4 now has the following footnote at the very beginning: "This is a chapter on the theory of supply-side economics, which may be safely passed over by readers who prefer a less abstract exposition of the subject." So much for a Vassar education!

litical authority..., and a tendency toward national decline" (p. 29). The very vibrancy of capitalism "depends not on automatic mechanisms [Gilder has little use for the perfect competition model which is itself egalitarian], but on the quality, creativity, and leadership of the capitalists" (p. 38). Gilder is an out-and-out elitist:

> [L]eadership is supply and public opinion is demand... leaders to the extent that they bear real authority, tend to create the views of the larger constituencies more than they follow them (p. 29).
>
> [S]uccessful politicians are engaged not in passive response to public demand, but in the active supply and marketing of ideas. *Supply creates its own demand, even in the political realm* (p. 29, italics supplied).
>
> The will of the people is often no more "spontaneous" or free of elite initiative and manipulation in politics than in economics. *Democratic masses cannot be generative or creative; they can merely react and ratify* (p. 38, italics supplied).

It is by the "experimental competition of elites" that capitalism generates its dynamism. It is a boiling cauldron of great convection currents within which the natural elite rise to the top, and the tired, worn-out elite, having done their thing, are cast down from whence they came. It is a rampant social and economic Darwinism, with elitist liberal arts colleges and universities guaranteeing the downward mobility of the effete children of the upper classes (those "humpty-dumpty heirs of wealth") to make way for the bluing of America. Look at Ronald Reagan and that millionaires' club called the U.S. Senate, most of whose members are self-made men (independently of ABSCAM), not to mention the president of Mobil Oil, the son of a Greek immigrant peasant.[9] "Material progress," Gilder tells us, "is ineluctably elitist: it makes the rich richer and increases their number, exalting the few extraordinary men who can produce wealth over the democratic masses who consume it.... *Material progress, although democratically demanded, is procedurally undemocratic*" (p. 259, italics supplied). It is the elite, not the masses, who are "our greatest and only resource... the miracle of human creativity" (p. 268).

And it is the welfare state's coddling of the poor that keeps them from participating in the economy by sapping their incentive to work and to improve their own lot by their own efforts. They

[9] It would, of course, be impolite to mention David Rockefeller, Gilder's great benefactor who staked him to an education at Exeter and Harvard.

have been turned, to use Charlie Wilson's felicitous metaphor, into kennel dogs sitting on their haunches yapping for the next hand-out, not hunting dogs alert and lean of muscle hunting for their food.

The textbook case of perfect competition, moreover, "has little to do with the central activity of capitalism, which is the turbulent process of launching new enterprises. . . . Perfect competition . . . excludes most supply-side behavior," since in equilibrium firms "can essentially affect neither supply nor demand" (p. 31). The very foundation of supply-side economics is that "producers collectively in the course of production, *create demand for their goods*" (p. 32, italics supplied): they are not kennel-dog "takers" of what the market gives them.

Capitalism's go-go people are the *very* rich. And it is not the role of the rich to "titillate the classes below, but to invest" (p. 62). The rich, unlike the poor, consume a small proportion of their income—except when high marginal tax rates and bracket creep force them to pour their millions into sinkholes: tax shelters and collectibles (gold, art, precious stones, etc.) that add nothing to productive capacity. "A successful economy depends on the proliferation of the rich" (p. 245) unfettered by the government and protected from the masses, who push misguided liberal politicians into counterproductive redistributive welfare boondoggles.

Since, to use post Keynesian terminology, the poor's average and marginal propensities to consume are unity (they are not savers, nor can they be in the nature of their circumstances), and the rich have a high marginal propensity to save, and since it is our tax structure that has sapped the vitality of capitalism, let the government use its tax powers *to redistribute income in favor of the rich*. This would, of course, require the cutting of welfare programs in order to force the poor to work for their own benefit and moral improvement.

Past redistribution efforts to favor the poor have only served, according to SS-ideology, to decrease incentives to work, by rich *and* poor. They have therefore decreased investment, productivity, and growth. The visible effects are increased unemployment, inflation, underground economic activity, tax shelters, and other sinkholes for the rich and, contrary to expectations, an increase in the level of poverty.

The poor can only be helped by lifting investment, which can be increased only by "the enriching mysteries of inequality" (p. 118). The poor do not choose not to work because of "moral weakness, but because they are paid [not] to do so" by welfare and subsidy programs (p. 68). Indeed, the welfare state has raised the marginal tax rate for the poor to the 100 percent level, or so the argument goes, trapping them into their dependency by making work unprofitable. Moreover, the male poor have been "cuckolded by the compassionate state" and driven out of the family unit, their own macho self-image shattered.

What we need do to help the poor is to change our tax structure radically—to make it less progressive by a greater use of *regressive* taxes, for, Gilder tells us, *"Regressive taxes help the poor"* (p. 188). The argument is as simple as it is simple-minded. Gilder writes:

> It has become increasingly obvious that a less progressive tax structure is ncessary to reduce the tax burden on the lower and middle classes. When rates are lowered *in the top brackets*, the rich consume less and invest more. Their earnings rise and *they pay more taxes in absolute amounts.* Thus the lower and middle classes need pay less to sustain a given level of government services. . . . *[T]o help the poor and middle classes, one must cut the taxes of the rich* (p. 188, italics supplied).

An ingenious argument: the cut in taxes on the rich will so stimulate output that the tax revenue increases from the rich alone[10] will allow tax cuts for the low- and middle-income classes. Once upon a time it used to be argued, to counter Marxists, that taxing the rich more would not generate enough additional revenue to help the poor because the poor are many and the rich few. Supply-siders add that regardless of their fewness, taxing the rich to *help* the poor serves only to reduce output, thus worsening the condition of the poor. Now the argument is that no matter how few the rich are, cutting *their* taxes will increase *their* pretax incomes to such an extent that government coffers will overflow to more than just compensate for the smallness of their number. He would have been on firmer ground had he included the multiplier-induced increase in the aggregate incomes of the poor and the middle classes as well. But even here there is a problem. Gilder's supply-side argument is a *growth* argument: that overall activity is powerfully dependent on the after-tax income *of the rich*, who alone are the dynamic growth force in a capitalist society.

The growth aspect of the argument has not escaped Jack Kemp (1979). Borrowing from a JFK speech, his leitmotif is: *A rising*

[10] Gilder misses the point, in support of his own argument, that the incomes of the middle class, at least, will also increase (through the multiplier), leading to a secondary rise in tax revenues.

tide lifts all boats. If factional strife and class struggle are to be avoided, growth must accelerate. Again, it is "the rich and powerful and creative—*a group relatively small in number*—[who] are ready to pull, if only they are not discouraged by government from doing so" (p. 31, italics supplied). And "the tax system [is] the key to spurring real economic growth" (p. 37). High taxes, especially on the rich, "impoverish the community at large." Robert Mundell is brought in to clinch the argument: "The level of U.S. taxes has become a drag on economic growth in the United States. The national economy is being choked by taxes—asphyxiated" (quoted in Kemp, p. 37). To which Kemp adds: "Tax relief is not so much an end in itself as a means of getting this economy moving again. Economic growth must come first" (p. 49). Then, of course, quarterback Kemp is an ardent Laffer curve team player. Cut taxes and revenues and growth will increase. Kemp would like to see the maximum marginal tax rate reduced to 25 percent. That should do it. A "growth-oriented tax policy [would] increase the tax base by increasing the volume of work, saving, and investment" (p. 102).[11]

V

Supply-siders know what causes unemployment: high taxes on the rich prevent the economy from rolling along at its full-employment potential. They also know what causes inflation: *taxes.* Since taxes *simultaneously* cause unemployment *and* inflation, supply-

[11] It occurs to me, though it has not to any supply-sider I know of, that there is a better way to achieve their goals than through cuts in the marginal tax rates—which are politically difficult to do to an appropriate degree (the Reagan Administration has cut the marginal tax rate from 70 to only 50 percent, or twice that which Kemp thinks is required), and even if done are too easily reversed in the next election. A better way would be a constitutional amendment (these things are getting popular these days) to deny the vote to the nonpropertied classes (as some of the founding fathers wished), and to the idle, nonproductive rich living on their inheritances. This disenfranchisement would serve as a spur for the "humpty-dumpty heirs" of the rich to climb down from their walls and avail us of their creative talents by reentering the real economy—though adequate inheritances would be allowed so as not to sap the incentives of the *working* rich to provide for their degenerate progeny. Family feelings run strong among the righ; they have not been sapped by welfare handouts, at least not the kind the poor get. Still another approach would be a profit-sharing program with the working class, in lieu of tax cuts for the rich, which would equally increase work incentives and restrain wage increases. But this is unlikely to appeal to supply-siders. Given Gilder's enamorment of elites, disenfranchisement is the better bet.

siders also have a theory of "stagflation," and a cure for it: *cut taxes.*

Borrowing from Paul Craig Roberts, a most solemn and unbending missionary, Gilder claims that high taxes act as a brake on production and that this *tax brake* causes inflation by reducing the supply of goods. Inflation is neither demand-pull nor cost-push. It is *tax-push* in that taxes "have an immediately inflationary impact on wages and prices" (p. 194). Gilder, on this, is a closet post Keynesian. His theory of inflation is a variation on Kalecki's markup theory of pricing. The base price of any marketable good is "the sum of . . . intermediate costs plus the share of *other costs passed on its price*" (p. 202, italics supplied). The costs of the welfare state induce higher taxes, whether outright or by bracket creep. And since "all final prices embody the pyramid of public services, paid for by taxes at every point of the productive system," there is a "*diffusion* through the price structure of the rising cost of government" (p. 203, original italics).[12] It follows, therefore, that "government, with its ever-proliferating . . . services and inefficiencies" (p. 203), is the chief cause of inflation. Taxes push up prices which then cause wages to rise and so on into the spiral. Inflation is *tax-push inflation.* Sidney Weintraub's equation reduces itself from $P = k(w/A)$ to $P = k(t)$, where t is the rate of increase in taxes used to finance an expanding welfare state.

Gilder is uncompromising: "Inflation is caused by taxes" (p. 190), *not by increases in the money supply.* Gilder is one supply-sider who has virtually no use for Milton Friedman and his monetarist epigones. "[I]t is self-destructive for conservatives to pretend that the inflationary impact of taxes on costs is chiefly a problem of the money supply" (p. 204). It is not. What is needed is to "economize on government." Prices are a function of government taxes, not the money supply. Gilder's rejection of Friedman is unequivocal—Friedman is a demand-sider, a variation on a Keynesian theme. In the first place, Friedman got it all wrong. He did not support the Kemp-Roth bill for its supply-side effect but "only because it would exert pressures for cuts in expenditures" (p. 191). He failed to realize that the effect of the proposed Kemp-Roth bill is "on business creativity and investment" (p. 191), i.e., the supply side.

[12] Although this has all the markings of a cost-push theory, Gilder apparently prefers tax-push, I suppose, on the grounds that taxes are not a *market* cost.

Furthermore, monetarists cannot easily define the money supply or control it "during periods of rapid economic change" (p. 195), and there is no historical evidence "that any particular level of money supply is uniquely favorable to economic health" (p. 202). Restricting the money supply to fight inflation can only serve to "dampen private sector growth," which alone is "the best way to fight inflation" (p. 202). "To say that the Federal Reserve should not accommodate government spending is, in practice, to say that business should pay" (p. 204). Moreover, "Any attempt to fight inflation by monetary contraction alone at a time of repeated shocks to supply will cause new, yet more destructive, and more permanent inflation" (p. 205). And to make sure we get the message, we have the following (p. 205, italics supplied): *"There is no practicable antiinflationary program except Lafferite economics and supply-side stimuli."*

The quantity theory of money has a fatal flaw: it emphasizes the demand side and fails to realize that the money supply is *passive*, that it automatically adjusts to the needs of trade. If "taxflation" is the explanation of inflation, then the money supply must and will expand to accommodate the higher levels of nominal GNP. To try to restrain it will only play havoc with the economy. Monetarists, like all other demand-siders, are misguided. They do not understand that "the expanding money supply makes it possible for private activity to continue despite the massive diffusion of taxes" (p. 205). In short, "the generation of the demand for money [takes place] through the production of goods: the supplies that create the need for a store of value [*sic*!] and a medium of exchange" (p. 218). Then in short bursts we get the following:

> No monetary policy can stop people from bidding up the real prices of a declining store of goods in an economy that is running down.
>
> The long-run answer to the Keynesian [and monetarist] concern with aggregate demand is not a concern with the money supply, which is another facet of aggregate demand. *The answer is an unremitting cultivation of the supply of new goods*—the source of creativity and expectation *that create the demand for money.*
>
> [M] onetary and fiscal prodigality—deficit spending and money creation —is only the *proximate* cause of inflation. . . . *[I]t is not altogether regretable at a time of steadily rising taxes.*
>
> A rigorously antiiflationary monetary policy would hurt small but rising companies more [which to Gilder are "the cutting edge" of capitalism],

> since they stand at the end of the credit queue. It is new business that suffers most when lendable funds decline. . . . [*A*] *monetarist attack on inflation . . . will not affect inflation as much as it will hurt legitimate business* (pp. 218-223, italics supplied).

And to drive the last velocity nail into Friedman's coffin, we have: "The money supply . . . is illusive. New forms of money and credit proliferate in the United States" (p. 226), making the money supply "enormously elastic." As in post Keynesian economics, the banking principle triumphs over the currency principle. And so, the end for Milton Friedman, a millstone for the Gilder New Right!

Other supply-siders, however, give increases in the money supply primacy in the explanation of the *initial* onslaught of price increases, with taxes serving to exacerbate an already existing inflation. To Wanniski inflation is caused, *initially*, by increases in the money supply in excess of the real rate of growth. When the quantity theory of money is wedded to Laffer's *wedge*, we get a different supply-side theory of inflation.

Wanniski notes two kinds of taxes: specific taxes and ad valorem taxes. Since specific taxes (which are generally regressive) are levied on "weight, volume or specific activity," and not on value, the Laffer wedge lessens with a monetarist-induced inflation. "All transactions in the economy feel a lightening of the tax wedge *after the initial turbulence of monetary expansion* [and] the economy enjoys a genuine expansion" (p. 114, italics supplied). Ad valorem taxes, which are in *proportion* to value, leave the Laffer wedge unaffected. But *progressive* ad valorem taxes widen the wedge, and the economy contracts as a result. In short, if excessive increases in the money supply lead to corresponding price level changes, and the wedge widens because of the progressivity of the tax system (bracket creep, even if tax schedules are unchanged) causing a fall in real output (the incentive effect of supply-side economics), then we are confronted with the simultaneity of inflation and unemployment—*stagflation*.

To Jack Kemp "Wages, profits and prices no more cause inflation than wet streets cause rain" (p. 101). To fight inflation the money supply must be brought under control and taxes cut to induce anti-inflationary increases in output (again, the supply-side incentive effect). Kemp, moreover, proposes to control the price level by returning to a strict gold standard. "With a restoration of dollar convertibility into some commodity of value [gold], *infla-*

tion . . . would be stopped dead in its tracks" (p. 114). When I read or listen to Jack Kemp, I find myself compulsively humming that old country-Western song "Drop-Kick Me, Jesus, through the Goal Posts of Life."

Obviously, supply-siders have to clean up their act on the inflation issue. For the moment, we leave them wallowing in their confusion. Post Keynesians and supply-siders, however, are agreed on one thing: *the Phillips curve is dead!*

VI

So far we have been talking about supply-side *theory*. What about *praxis*? And the *unity* of theory and praxis, to use a Marxian term? With much fanfare on February 18, 1981, the Reagan Administration released its *Program for Economic Recovery*—the NEP for our time, from the other side of the political spectrum. It is basically a supply-side document, though with some startling variations on the supply-side theme. It begins with a clarion supply-side call. Its economic recovery program (ERP) is designed to "rekindle the Nation's entrepreneurial instincts and creativity . . . [by] reducing tax burdens, increasing private savings," and by releasing "the strength of the private sector" (p. III:1). It proposes to increase the growth rate by "providing incentives for individuals to work, save and invest . . . by reducing the growth of government" and by "reviving the incentives to work and save" (p. III:1). Federal regulations are also to be drastically cut, and monetary policy will consist of "a predictable and steady growth rate in the money supply" (p. III:4).

Here the Reagan Administration breaks with Gilder's antimonetarism and in the process gets caught in a series of inconsistencies. Inflation, for the Reagan people, is not simply a matter of the money supply, and in this the ERP appears to agree with Gilder; but this reconciliation quickly breaks down. The *primary* cause of inflation is "uncontrolled government spending, . . . the tendency of government to take an ever-larger share of . . . resources, . . . [and] excessive deficit spending." The solution to inflation, low growth, and unemployment, as for all supply-side theorists, is to release the tax brakes—especially on the productive rich—in order to induce harder work and increased savings and investment. *All* of our problems are to be solved by a strict adherence to *supply-side fiscal policy*. Monetary policy is to play a subordinate, supporting role. Given that government spending, deficits, and the crowding out of the private sector are the primary causes of inflation, excessive money supply bursts compound inflation, thus further driving up wages, prices, and interest rates—with nominal interest rates being "largely a mirror of price expectations," a markup over real interest rates. Unduly restrictive monetary policy, on the other hand, creates "uncertainty [and] undermines long-term investment decisions and economic growth" (p. III:22). What is needed is a "steady, gradual reduction [of money and credit growth rates] over a period of years," which will make it possible "to reduce inflation substantially and *permanently*" (p. III:22, italics supplied)—which is about as monetarist as one can get.

By having monetary policy focus "on long-term objectives, the resultant restraint on credit and growth would *interact* with the tax and expenditure proposals to lower inflation as well as interest rates" (p. III:23, italics supplied). Friedman's monetary rule is to be followed: by moving to "a 4 to 5% annual growth path through 1986 . . . the general rate of inflation . . . [will] decline to less than 5% annually" (p. III:24).

The assumption, of course, is that tight money has no output and employment effects and will thus not undermine expansionary supply-side fiscal policy. As the *Staff Report* of the Congressional Budget Office observes, "previous attempts to reduce inflation with tight money have initially resulted in higher unemployment and decreased output, and only subsequently in lower inflation . . . after a lag of perhaps five to ten years" (p. 11).[13] "[I]t is by no means certain," concludes the CBO, "that monetary policy —however steadfast and credible—will translate wholly and quickly into reduced inflation" (p. 11).

The CBO also takes note of a serious inconsistency in the Administration's monetary-rule approach to monetary policy. If the real rate of economic growth is to be increased while sharply reducing the money supply growth rate, then velocity will certainly have to increase. And if the growth rate in velocity is positive, it is highly unlikely that interest rates will go down, as the Administration's game plan predicts, from a ninety-one-day TB rate of 11.1 percent in 1981 to 5.6 percent in 1986—a convenient date suffi-

[13]The CBO's *Staff Report* of March 1981 is an "Analysis of President Reagan's Budget Revisions for Fiscal Year 1982." It is a devastating document and, not surprisingly, caused an uproar in Washington, with David Stockman leading the counterattack. Others in the Senate have been pressuring for Alice Rivlin's resignation as Director of the Congressional Budget Office.

ciently in the future for everyone to debate and forget.

Supply-siders believe that interest rates are "largely a mirror of price expectations";[14] and since the inflation rate is expected to fall in the Administration's supply-side model (because of a tax-induced increase in output), it follows, to their satisfaction, that interest rates will fall as dramatically as the fall in the expected inflation rate.[15] But then velocity, as the CBO points out, is supposed to be "a rough measure of the demand for money relative to supply" (p. 10), with the interest rate representing the price of money. Supply-siders are therefore caught in a bind: How can an excess demand for money lead to a *fall* in its price? It is all very confusing and offers technical evidence that from Wanniski to Kemp to Gilder to Stockman there is a strange opaqueness on the role of money in their theories of inflation.

VII

The Administration's first order of business will be a cut in the "high marginal tax rates on business and individuals [which] discourage work, innovation, and investment necessary to improve productivity and long-run growth" (p. III:4). The second order of business will be to cut nondefense expenditures drastically.

On tax cuts the Reagan Administration agrees with supply-side theorists that high marginal tax rates reduce work effort, and that the "tax system has been the key cause of our stagflation" (p. III:6). There is also agreement that the progressive marginal tax rates of the *personal* income tax should be cut, but skewed in favor of the rich—who do most of the saving and investment. But the Reaganite practioners are also for sharper cuts in the business corporate income tax, greater investment tax credits for business, and accelerated depreciation (the 10-5-3 plan). Here they part company with the theorists.

[14] From the President's *Report*: "Central to the new policy is the view that expectations play an important role in determining . . . interest rates" (p. III:24).

[15] In the first half of 1981, the inflation rate eased significantly, yet interest rates soared under Volcker's brand of monetary policy. One explanation could be that the financial sector has no confidence in Reagan's ERP and expects large federal deficits, leading to continued inflation; that is, *their* inflationary expectations have not abated even if the inflation rate has objectively fallen. The Reagan Administration is being hoisted on its own *expectational* petard.

Progressivity in tax rates, argues Wanniski, applies to business "to a limited degree" (p. 224). It is mostly *individuals* who are sensitive to inflation-induced bracket creep. And it is individuals and individualistic venture capitalists who constitute the driving force behind a dynamic capitalism, as we have been told *ad nauseum*. Existing big business resists innovation—a touch with a Marxist flavor—and worships at the altar of the status quo. They slow down the convection currents of capitalism. Apparently Ronald Reagan, their most powerful disciple, disagrees. Taxes have cut down the after-tax return on capital investments by business, and the practice of using historic rather than current replacement costs as a basis of capital depreciation has vastly overstated nominal profits subject to taxation.

Gilder and Kemp (who received a strong assist from Wanniski in the writing of his book) are of a different mind. First the "radical" Kemp:

> [C]onfining most tax relief to retained corporate profits, through such devices as accelerated depreciation or an investment tax credit, *keeps capital locked into established firms*. By focussing on the *individual* investor, on the other hand, we can stimulate risk investment in innovative *new* firms that are the main source of *new* products and *new* technologies (pp. 66-67, italics supplied).

Gilder, the other "radical," is equally outspoken on the issue:

> Investment tax credits and rapid depreciation allowances—although better than no tax cuts at all—tend to favor the recreation of current capital stock than the creation of new forms of capital and modes of production (p. 243).

Supply-side *theorists* prefer cuts in personal income taxes and in capital gains taxes (which, according to Kemp, "give investors the incentive to buy shares with low current dividends but good, though risky, potential for growth" [p. 67]), than the cutting of corporate income taxes (which are proportional for the larger firms) and the granting of investment tax credits and accelerated depreciation allowances (which also favor the bigger firms). It is clear that Reagan is not a purist. He has many friends in big business and is not as "radical" as Kemp and Gilder. He does agree, however, on the dismantling of the welfare state.

The cuts in nondefense spending will do wonders for the work incentives of the poor (according to supply-side theory). There will be cuts in medicaid, child nutrition programs, certain social security benefits (e.g., minimum payments), food stamps, unemployment benefits, youth training and employment programs, public service employment, income-assistance payments (AFDC), and a whole medley of other social-service programs as well. The geographic distribution of these cuts is almost certain to hit the already depressed Northeast and Midwest harder than the Sunbelt states. On the other hand, defense expenditures, according to the CBO *Staff Report*, are scheduled to increase *in real terms* between 1980 and 1984 by an annual average of 7 percent, compared to a nondefense spending rate of growth of 1 percent *in nominal terms.* Real nondefense spending will be 15 percent lower in 1984 than in 1980 (see *Staff Report*, p. xiv). And here is a problem for supply-side theorists.

The original Kemp-Roth 30 percent tax cut, to be phased in over a three-year period, plus the revenue cost of faster tax depreciation of capital expenditures will approximately *offset* the inflation-induced income tax increase (bracket creep) and the scheduled rises in social security taxes. Furthermore the nondefense cuts will be diverted to finance the planned jump in defense expenditures. In effect there will be no real tax cut, merely the suppression of bracket creep, and no substantive decrease in overall government expenditures—although there will be an enormous redistribution of the social product in favor of the rich. Supply-side *praxis* has apparently left supply-side *theory* in the lurch. *The Administration's program is a massive redistribution gambit with a reverse twist, not a growth scenario based on supply-side theory.*

What then about the Laffer curve and our position on it? If there is, in effect, no net real tax cut, then we are stuck on its upper reaches—where supply-side theorists are convinced we are. The President's *Program* (which does not mention the Laffer curve) pays lip service to the idea, for the Laffer curve can only be *inferred* from page IV:6 of the President's *Report*:

> [D]espite substantial tax rate reductions and the steadily falling inflation rates in the Administration's economic scenario, *Federal receipts*, including modest amounts from the President's user fee proposals, *would grow by nearly 10% annually* (italics supplied).

The cut in taxes, it would seem, coincides roughly with the increase in government tax revenues. In that case we will be smack on the bellybutton of the Laffer curve. *Oh, happy day!*

It seems fairly clear that supply-side praxis and supply-side theory are in collision, between the claim of lowering the real tax rate and inflation bracket creep. Of course, supply-side practitioners will always have Congress to blame if things don't work exactly right, and supply-side theorists will be able to squirm *their* way out—taxes weren't really cut or not cut enough. Both practitioners and theorists have their escape hatches to the ready.

VIII

There is one final mystic bit of outstanding supply-side business: *the savings ratio*. Supply siders have made much of the low ratio of savings to GNP in the United States, contrasting it unfavorably with the current two favorites—Germany and Japan—while conveniently ignoring the disparate postwar defense spending ratios. Supply-side wisdom attributes the low U.S. savings ratio to the high marginal rates of taxation, of course. Cutting them will restore savings to their proper level and induce the needed investment for an increase in supply. At the same time, the tax cuts will also call forth a greater work effort on the part of the rich and the not-so-rich—though not of the poor whose marginal tax rates, because of a perverse welfare system, are at the 100 percent level.

On the issue of work effort, higher after-tax returns for individuals could as well cause *less* work effort in favor of more leisure time. Also, there is no guarantee that investment, as a result of a greater after-tax business income, would increase. Bountiful corporate cash flows could well lead to corporate mergers instead of new investment—as brilliantly exemplified by the recent behavior of oil companies. But perhaps the most depressing doubt is the cocksure, simple-minded relationship assumed between saving and the marginal tax rate. It all hinges on whether individual and business saving is dominated by *stock* goals or *flow* goals—on whether savings are destined for specific purposes or are conceived as a *proportion* of disposable income.

"Economists," argues Robert Eisner (JEC, 1980), "are far from agreed that higher after-tax yields have much effect on savings or even a direct effect. To the extent people save in order to have spending power at a future time, such as retirement, lower returns make it necessary to save more" (p. 17). Moreover, adds Eisner, "There is relatively little sound evidence that the rate of return on saving has much to do with total saving" (p. 10). To Eisner "The single greatest encouragement we can give to saving and investment . . . is to see to it that people can make choices in business and make their decisions *in a climate of prosperity and full employment*" (p. 9, italics supplied). Accordingly, government policy would be better directed to that most serious market failure in capitalist society—"the market failure of unemployment" (p. 18).

Keynesians of either the conservative-liberal or more radical post Keynesian stripe would agree with this assessment. And so would François Mitterand. Ronald Reagan takes his place alongside Margaret Thatcher.

IX

Supply-side economics suffers from an acute tax cut fetishism. Tax cuts have become an object of irrational reverence. Some people bay at the moon, others worship the sun by cooking themselves in it, and still others burn incense and practice the black arts. For supply-siders the hangup is taxes. They can't help it. Taxes cause *all* of our troubles, and tax cuts will solve everything—especially if tilted toward the rich. It is because of *the poverty of wealth*, in the sense that the rich are prevented by government from being richer still, that the poor are poorer than need be.

There is, however, another sense in which a poverty of wealth exists, and that is in the intellectual poverty of supply-side ideas. They are the *reductio ad absurdum* of capitalism. Vulgar apologists for the worst features of capitalism are trying hard to make vulgar Marxism true. And in the hands of Ronald Reagan, the mixed capitalist welfare state runs headlong into a counterrevolution of the first order, and a major legitimation crisis.

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THE CRISIS OF FAITH

by

Stephen Rousseas
Vassar College

I

Prevailing social theories are convenient constructions of reality which seek, more often than not, to justify whatever is by forcing the 'facts' of social existence into preconceived ideological boxes. They are, when things are going well, celebrations of the status quo, and the main spokesmen for establishment theory serve as the legitimators of power and those who wield it. Immutable 'laws' are propounded which 'prove,' on scientific grounds, that the system is just, and being just, predestined to go on forever. When things are not going too well, the theoretical guardians of the conventional wisdom tend to scold and to attribute the malfunctioning of the system to violations of sacred maxims.

Such was the state of affairs, a little over fifty years ago, with the onset of the Great Depression. It was by far the greatest challenge American capitalism had to face since the Civil War. On a black Thursday the Stock Market crash wiped out the paper wealth of the newly rich, and massive bank failures cleaned out the life savings of many of the not-so-rich. Real output fell by one-third, factories closed, and unemployment (as officially measured) soared to 25 percent of the labor force.

According to the conventional theory of the time, it could not and should not have happened.

In its purest and most ideal form, capitalism was seen to operate within a system of competitive markets. Markets were simply the institutional arrangements within which buyers and sellers confronted each other. No single participant was big enough, either by the amount of a particular good or service he wished to purchase or the amount he was willing to sell on the market, to have any noticeable effect on price. Power was so widely diffused as not to be a social problem. All prices were determined by the free interplay of individuals in unfettered markets, and all players sought their own individual private gain in total disregard for the welfare of others or, for that matter, for the welfare of society as a whole since the welfare of the whole was assumed to be the simple algebraic sum of its constituent parts. The market system automatically assured that the greatest public good was to be derived from the greatest private selfishness. When not tampered with, the market transformed the innate selfishness of man into a natural and unintended harmony of interests.

Such was the system that Adam Smith had wrought in 1776 when he published his monumental work, the Wealth of Nations. The individual, he wrote, "intends only his own security and... intends only his own gain, and he is in this...led by an invisible hand to promote an end which was not part of his intention." And that unintended "end" was the social welfare, itself the by-product of the free-wheeling forces of an impersonal market system, which also seemed to guarantee an equitable distribution of the social product among all members of society. Above all, as Adam Smith's system was subsequently refined, capitalism automatically tended toward full employment along a dynamic growth path. Any lapse from this ideal would be automatically corrected by built-in, spontaneous market forces. Changes in relative prices, in other words, would assure the optimal allocation and use of all resources. Changes in the level of real output, and hence employment, by being ephemeral, could therefore be ignored. Capitalism, by its very nature was in tune with the harmony of the universe. Everything was in exquisite balance. Although the "laws" of economics were patterned after those of Newton, they were different in one essential respect. Unlike the laws of the physical universe, the laws of economics could be violated, with disastrous results.

Adam Smith was not unaware of the great perils confronting freely competitive markets. "People of the same trade," he wrote, "seldom meet together, even for merriment and diversion, but the conversation ends in a conspiracy against the public, or in some contrivance to raise prices." The threat of monopoly was always lurking in the wings. Government, however, was an even greater threat to the market system than the abuses of monopoly power. In 1876, one hundred years after the publication of the Wealth of Nations, the Political Economy Club of London met to honor the event. "One of the great dangers which now hangs over this country," warned the Treasurer of the Club, "is that the wholesome spontaneous operation of human interests and human desires seems to be in course of rapid supersession by the erection of one Governmental department over another... and by the whole term of Parliament being taken up in attempting to do for the nation those very things which, if the teaching of the man whose name we are celebrating today is to bear any fruit at all, the nation can do much better for itself." It was the role of political economy, as laid out by Adam Smith and his successors, to "reduce the functions of government within a smaller and smaller compass." The chairman of the centennial celebrations reinforced the treasurer's inquietude by stating that the primary and overriding duty of economists lay in "propagating opinions which shall have the effect of confining government within its proper province and preventing it from all manner of aggressions and intrusions upon the province and the free agency of the individual."[1] The sole function of government is to provide for the national security, to enforce and uphold legal contracts, and to promote civil law and order.

[1]Quoted in T.W. Hutchison, A Review of Economic Doctrines, 1870-1929. London: Oxford University Press, 1953; pp. 4-5.

II

These ideas reigned supreme -- at least on the level of ideology -- up to the crash of 1929. True, panics and cycles were a part of our past, but they were fleeting incidents in a rapidly growing, exhuberant economy engaged in the heady process of creative destruction. Cycles were seen as temporary phenomena, an unavoidable part of capitalism to be borne in stoic silence. A leading school of economics attributed them to sun spots. There could therefore be no moral responsibility for the short-run suffering of the mass of people, and if the poor suffered unduly, it was because of their failure to limit their daily consumption in good times in order to provide for the inevitable rainy days. For others, cycles were purely monetary phenomena, attributable to a perverse elasticity of the money supply, which the creation of the Federal Reserve System in 1913 had solved once and for all -- or so it was thought. American capitalism, in the 1920s, was seen by the economics profession as marching forward resolutely on a plateau of infinite prosperity. The era of Giant Capitalism in the 1910s was downplayed; the idealized market system continued to hold sway. Then came the collapse.

One of the great axioms of our existence is: <u>What is, is possible</u>. A corollary is: <u>And if it is possible and does exist, then it is the theory that has to go, not the real world</u>. Conventional market theory, however, held on. It argued that nothing was wrong with the theory; it was the real world that was out of whack. The 'laws' of economics had been transgressed, the economy was living in sin, and the wages of sin are retribution. We were being punished for our evil ways. Apply the anti-trust laws, break up the unions, take the government out of the business of running the economy, and market forces would quickly move us back to the natural level of full employment. With flexible market prices, flexible wages, and no governmental interference with market forces, adjustments in relative prices would result in the reallocation of resources needed to restore full employment. The policy recommendations followed logically from the supporting theory, but they were politically naive. No elected government was about to take on big business and big labor at the same time. Apart from political considerations, such policies would further wreck the economy by trying to go back to something that never existed in the first place, except in the mythology of the underlying legitimating theory.

The Great Depression could not be denied. It was there in all its black majesty and it was not just another transient rainy day; it was a storm that threatened the very survival of the system and there was no new theory to provide a quick fix; Keynes's General Theory (1936) came later. Rejecting the naive policy nostrums of conventional theory, the political response in the United States was a pragmatic groping for solutions which led to that amalgam of policies called the New Deal. Its public works projects, its relief for the poor, its civilian conservation program for unemployed youth, the National Recovery Act (NRA), and the establishment of a social security system -- all these gave some measure of hope to a dispirited nation. The Federal budget went from a $737 million surplus in 1930 to a $4.5 billion deficit in 1936. The public debt more than doubled. It went from $16 billion in 1930 to $34 billion in 1936. By 1940 it had reached $43 billion, a phenomenal amount for its time that led to repeated warnings of bankruptcy and impending disaster. Yet, in retrospect, the New Deal did too little rather than too much. After a slow recovery, the U.S. economy dropped sharply once again in 1937. It began its full recovery only with the 1939 onset of World War II in Europe, and with its own direct involvement in 1941.

As World War II was coming to an end and victory was assured, the old fears resurfaced. As a warning to its corporate subscribers, Leo Cherne's Research Institute of America predicted (on expensive linen paper) 11 million people unemployed in the immediate postwar period. The Pabst Blue Ribbon Beer Company announced a competition, with a $25,000 first prize, for the best 2000 word essay on how to avoid sliding back into the mass unemployment of the prewar period. The National Planning Association was established in Washington and quickly recruited a staff of professional economists to work on a national plan for the postwar reconversion of the economy. The British White Paper of 1945, for the first time in modern history, proclaimed the government's responsibility to provide for full employment in the postwar world, and in the United States the Employment Act of 1946 committed the federal government to the maintenance of maximum employment, full employment being too controversial for the U.S. Congress. And in the late 1940s the United Nations convened a Committee of Experts (Nicholas Kaldor, Arthur Smithies, John Maurice Clark, Pierre Uri, and E. Ronald Walker) to propose National and International Measures for Full Employment. Governments (particularly that of the United States) were to be held responsible for the overall high-level performance of their economies, which was to be assured by the adoption of appropriately stabilizing fiscal measures. And it was on this basis that we entered the postwar period with some trepidation but armed with the new Keynesian theory for managing aggregate demand. Government was to compensate for the occasional market failings of the capitalist system, with especial emphasis on the 'free' market's failure to provide for full employment.

Keynesian economics gathered momentum in the postwar period, and quickly provided, ex post facto, the intellectual rationale for the earlier pragmatic policies of the New Deal. In a stagnant economy operating at considerably less than full employment, government expenditure and tax policies were to be used as a means for stimulating aggregate demand. Personal income tax cuts increased disposable income. Consumption expenditures would increase as a result which, in turn, would stimulate private investment and output. Business tax cuts, on the other hand, would work more directly by providing additional cash flows to permit businessmen to follow up on their rising profit expectations by undertaking new investment -- thereby moving the economy closer still to full employment. On top of this, government expenditures in the form of public works would hire the unemployed and pump additional purchasing power into the economy via the construction of dams, roads, City Halls, schools, hospitals and other forms of social capital. In addition, Governmental transfer payments in the form of relief for the unemployed would alleviate human suffering in the interim until the economy could get moving again.

The government's impact on output and unemployment would be primarily through the government budget. Its tool would be an expansionaly fiscal policy and deficit financing. Its role would be compensatory -- temporarily filling in the gap between actual private outlays and the amount of aggregate demand needed to achieve a full employment economy. Monetary policy was to play a lesser role. In the 1930s and the immediate postwar years, the banking system was awash in a sea of liquidity. The excess reserves of the banking system could not of themselves stimulate an increase in the demand for loans without the prior play of fiscal policy.

Prior to the War, the Temporary National Economic Committee (TNEC) in Washington had held hearings on the failure of the economy and published volumes describing interlocking corporate directorships and monopolistic constraints of trade. By the onset of the postwar period, the market system had been discredited and the end of laissez-faire proclaimed. There was no natural tendency of capitalism to move toward full employment. Indeed, within a Keynesian framework, capitalism could well rest at a chronic level of underemployment indefinitely. Theories of secular stagnation abounded, and an increased role of government was seen as the only way out of the morass. This was the state of affairs when World War II broke out. It was left to the postwar period to build on the Keynesian foundation and to refine its policy tools to their highest degree of "perfection" in the Kennedy Administration -- until Keynesian theory itself came onto hard times in the 1970s.

III

For the most part, the postwar period was a success. The fear of another Great Depression was replaced by a series of mild, short-lived recessions. The trend of real output, real wages and productivity was upwards and inflation, by current standards, a relatively minor problem. Everyone was a Keynesian, including the Republicans, or so Walter Heller said at the end of his tenure as Chairman of Kennedy's Council of Economic Advisors. Then came the 1970s and the problem of stagflation -- low growth and high unemployment and inflation. Keynesian economics itself was now on trial.

A retrospective on the postwar period was held in 1980, on the occasion of the sixtieth anniversary of the influential National Bureau of Economic Research (NBER). At its conference on *The American Economy in Transition*,[2] participants were asked to review the overall postwar performance of the American economy from the point of view of their specialties.

1980 was not a good year. The economy was once again in serious trouble. Echoing the Treasurer of the Political Economy Club of London in 1876, Martin Feldstein, a leader of the current counter-revolution and host of the Conference as director of the NBER, attributed the poor performance of the American economy to government interference. The worm had turned. "There can be no doubt," he wrote, "that government policies...deserve substantial blame for [our] adverse experience" [p. 3]. Government regulations, income transfer and social insurance programs, and the inhibiting tax effects on capital accumulation, had sapped the vitality of capitalism. Feldstein's views, however, were hardly reflected in the papers of his main participants. Instead of a return to "the years of chaos and depression," the postwar economy, according to Benjamin Friedman, "entered an era of stability and prosperity" with not only a higher average growth rate in the postwar years "but also a smaller variability of that growth" [pp. 11-13]. The "categorical imperative" of

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[2]Martin Feldstein, ed. *The American Economy in Transition.* Chicago: University of Chicago Press, 1980. Page references of contributors to the NBER conference refer to this volume.

postwar policymakers, in the opinion of the late Arthur Okun, was the avoidance of the Great Depression, and in that they had largely succeeded. The business cycle had been tamed -- or at least brought within politically tolerable limits. This new-found stability, moreover, was greater than at any other time. "The standard deviation of real GNP around its growth trend," wrote Okun, "was about one-fourth as large as it had been in 1900-45, and only half as large as in the 'golden age' of 1900-16, 1920-29." Where expansions averaged 26 months and contractions 21 months, from 1854 to 1937, the postwar expansions had an average duration of 48 months with contractions compressed to an average of 11 months. "This quantum jump in stability," argued Okun, "must...be credited to public policy. _It was made in Washingon_" and it was "the compositional shift" to a larger public sector GNP share that constituted "the largest single stabilizing element." The American economy's sensitivity to cyclical fluctuations, was markedly reduced. In this context, the growth of government transfer payments was a critical development. Although the postwar record of macroeconomic policy "in dealing with relatively minor accidents...is mixed," Keynesian monetary and fiscal policy was eminently successful in avoiding catastrophe. To Okun, the success of postwar economic policy was to be measured "_not in dollars of real GNP, but in the survival of United States Capitalism_" /1980, pp. 162-63, 168, italics supplied/.

Okun's assessment of the postwar performance of the U.S.

economy is amply reinforced in Alan S. Blinder's analysis of the postwar distribution of income. From 1947 to 1977 "real consumption per capita increased by more than 80 percent." At the same time "the basic necessities of life -- food, clothing, and shelter -- commanded ever decreasing shares of the consumer budget." The net result was a drastic improvement in "the average level of economic well-being" as well as in its content /p. 433/. Yet despite the increasing levels of per capita real income, the distribution of income remained virtually unchanged, with Gini ratio[3] ranging from a low of .40 to a high of

[3]A Lorenz curve compares the cumulative percentage of family income to the cumulative percentage of the number of families. Perfect equality (a straight-line Lorenz curve) means that 25 percent of the total number of families get 25 percent of total family income, 50 percent of families 50 percent of income, and so on. A bowed Lorenz curve implies a less than perfect distribution of income. The Gini ratio is a measure of the area between the linear and the actual Lorenz curves as a proportion of the total area. It is therefore a numerical measure of the degree of inequality in the distribution of income. The higher the Gini ratio, the higher the degree of inequality.

.42, with the mean smack in the middle at .41. Although there was little change in the postwar distribution of income, it was "noticeably more equal than the distribution of 1929" (p. 435). Despite this improvement, however, the United States continues to have a higher inequality of income distribution than many other industrialized countries, and has the dubious distinction of competing with France for the worst among the OECD nations.

According to Blinder, "the richest fifth of American families received eight times as much income as the poorest fifth" (p. 436). To Blinder, this constant 8:1 postwar ratio, though better than in the prewar period, is nevertheless "a very substantial income gap."

The constancy of the postwar income distribution is in large part due to government transfer payments -- both in kind and in cash, with the latter playing a more significant role. Transfer payments (welfare, aid to dependent children, food stamps, public housing and employment, medical services for the poor, etc.) as a proportion of GNP rose from 0.7 percent in the 1920s to more than 10 percent for 1973-79. To Robert Gordon, "the growth in the size of government after 1947 was mainly reflected in transfer payments rather than in goods and services. The combined spending on goods and services by Federal, state, and local governments as a percentage of GNP "exhibited no increase at all between the 1957-67 decade and the most recent 1973-79 subperiod." The increase in the size of government in the postwar economy must therefore be attributed to transfer payments -- which served the dual function of preventing a deterioration in the distribution of income in the postwar period while simultaneously adding to the stability of the postwar economy. Since "the lower income strata receive a disproportionately large share of transfers," according to Blinder, "it is clear that cash transfers pushed the distribution of income in the direction of greater equality during the postwar period" (p. 446).

But what of the problem of poverty in the postwar era? As Blinder points out, "Income is a continuous variable, whose distribution can be estimated. Poverty, however, is a dichotomous variable: a family is either poor or it is nonpoor. To decide who is poor, we must place a 'poverty line' somewhere in the income distribution...and count how many families (or people) fall below it" (p. 454). Whether using the official "absolute" standard of poverty (based on a basket of goods adjusted for inflation) or a "relative" standard of poverty (those with incomes 44 percent below the median income, for example), Blinder finds that when transfers are deducted from income, poverty goes up from 1.8 to 21 percent on the absolute standard and from 15.4 to 24.1 percent on the relative poverty standard. Government transfer payments must therefore also be seen as a critical factor in the amelioration of poverty.

In the postwar period, there was a marked decline in officially defined poverty during the 1960s largely because of the War on Poverty programs of the Johnson Administration. Between 1965 and 1976 Blinder found a 24.4 percent decline in the poverty rate, attributed almost in its entirety to increased transfer payments; without them the level of poverty would not have declined. In summary, transfer payments are clearly responsible, in great part, for the improvement of the postwar distribution of income over its prewar distribution, for its constancy over the past 35 years, and for the amelioration of poverty. In conjunction with macroeconomic policies, they also contributed to the greater stability of the postwar economy. In short, the redistributive and stabilizing activities of the government have played a positive role in the postwar performance of the American economy -- with the redistributive impact largely the result of "the rapid growth of cash transfers /and/ ...the War on Poverty..., /as well as/ on the equally rapid growth of transfers in kind,... /and/ other programs such as affirmative action guidelines, equal opportunity and antidiscrimination laws" (p. 473).

However well we may have done in improving the distribution of income and preventing its deterioration over the postwar years, the fact remains that income is a flow dependent on the stock of wealth. What of the distribution of wealth in the United States, about which we know considerably less? The distribution of wealth is worse. Blinder cites one study, based on the same 1966 population, which found a Gini ratio of .76 for wealth compared to .43 for income distribution (p. 466). The available evidence also seems to indicate that wealth inequality is relatively stable with no trend discernable. It should be obvious that an increase in the inequality of wealth would have a marked impact on the distribution of income, particularly if government tax policies were drastically changed to favor the accumulation of wealth by the already wealthy and even moreso if, at the same time, the welfare aspects of government transfer payments were subject to substantial cuts -- a point that will be reinforced in our discussion of the supply-side economic policies of the Reagan Administration. There is more to social welfare programs, as Wilber J. Cohen has emphasized, than Gini ratios and Lorenz-curve shifts (p. 493). There is the "larger context" of hopes and aspirations and the very legitimation of capitalism that is at stake.

IV

Modern post-industrial capitalism has survived as long as it has because of one unique aspect of its historical development: its flexibility and its ability to respond to changed circumstances. Unlike the Bourbons and the Romanoffs, capitalism has been able to defuse potentially threatening situations and to adapt along lines that assure its continuation. It has been this enormous elasticity of capitalism, within a relatively democratic context, that has confounded Marxian analyses of capitalism's 'internal contradictions' which, according to a mechanical dialectic, guaranteed its demise in a bloody collapse. It has been capitalism's ability to place "an iron bit in nature's mouth" that has enabled it to co-opt its opponents through higher and higher levels of real income. The key has been in a virtually limitless accumulation of capital and the growth that goes along with it. And it is growth that has served, up to now, to legitimate the capitalist system and defuse the distributions of income and wealth as politically destabilizing forces. As long as growth and capital accumulation continue, distribution is not a political problem. There can be no legitimation crisis; the system is seen and accepted as just. It is only when growth becomes the 'problematic' that capitalism is delegitimated and distribution repoliticized.

This is exactly what happened in the 1930s. The economic crisis was transformed into a social and political crisis with a resurfacing of class antagonism -- as Britain is now experiencing in the wake of Margaret Thatcher's policies. The problem in the 1930s was that investment, or increases in the means of production (the physical stock of capital), was largely a private matter in which the state had no direct role to play. The government's response to the Great Depression was to try to influence investment decisions indirectly by encouraging consumer spending via personal income tax changes and transfer payments and, more directly, by trying to organize businesses into huge cartels under the NRA and by outright grants and subsidies to business via the Reconstruction Finance Corporation (RFC). The postwar growth of government was the result of these policies, with cuts in corporate income taxes, investment tax credits and accelerated depreciation the modern and softer variations on the New Deal theme.

During the late 1950s up to the U.S. involvement in the Vietnam War, the postwar performance of the economy was, as we have seen, largely successful -- in comparison to the trauma of the 1930s. The business cycle was still with us, but brief recessions were now followed by larger expansions. The cycle had been tamed. So much so that liberals were quite satisfied with themselves. Political sociologists, such as Seymour Martin Lipset and Daniel Bell, loudly proclaimed the end of ideology. And with only a year into his presidency, John Fitzgerald Kennedy picked up the theme in two major pronouncements. Speaking before an Economic Conference in Washington (May 21, 1962) the 'liberal' President Kennedy, who had surrounded himself with prominent, "fine-tuning" Keynesians, argued that "most of the problems... that we now face, are technical problems, are administrative problems. They are very sophisticated judgments which do not lend themselves to the great sort of 'passionate movements' which have stirred this country in the past." A month later, in his Yale University commencement address, the President elaborated on his end-of-ideology theme:

> "[T]he central domestic problems of our time...do not relate to basic clashes of philosophy and ideology... What is at stake in our economic decisions today is not some grand warfare of rival ideologies which will sweep the country with passion but the practical management of a modern economy. What we need are not labels and cliches but more basic discussion of the sophisticated and technical questions involved in keeping a great economic machinery moving ahead...political labels and ideological approaches are irrelevant to the solutions."

President Kennedy's mentor, intellectual-in-residence and sometimes speech writer, the historian, Arthur Schlesinger, Jr., had written an article a few years earlier for the New York Times Magazine Section (August 4, 1957) asking: "Where Does the Liberal Go From Here?" In it, Schlesinger described the two sources of liberalism as "the vindication of the individual against economic privation and despair, /and/ the vindication of the individual against moral and spiritual frustration." He then went on to state that the vindication of the individual against privation and despair had been largely achieved in the postwar period by "the most brilliant explosion of creative social thought this country has ever seen." He was convinced that modern mixed capitalism had solved its major economic problems. All that remained was a minor cleaning up operation. The problems of yesterday had been solved in the context of today. "Few liberals," he argued, "would seriously wish today to alter the mix in our present economy." Having solved virtually all of our economic problems stemming from the 1930s, what we now needed was a "new" liberalism which would "recover /its/ deeper roots in the American cultural tradition /by shifting its/ focus from economics and politics to the general style and quality of our civilization." Creative spontaneity could now be let loose in an economically secure world. The problem was no longer economic unemployment but that no less terrible, though more intangible, problem of "spiritual unemployment." What this new breed of liberals must do is "to help prime the pump, not economically, but ethically." Too early for Schlesinger's and President

Kennedy's metaphysics to have been set in motion, one defeated Democrat in the elections of 1952 was heard to lament, "The trouble is, we ran out of poor people."

To a large extent, this celebration of the status quo is reflected in the sixtieth anniversary celebration of the NBER, except for one troubling development: the 1970s. The consensus politics of the 1950s and early 1960s began unravelling with the inflationary impact of the Vietnam War generated by the guns and butter policies of the Johnson Administration. And it was during this time that monetarism challenged the conventional widsom of Keynesian economics with its famous restatement of the quantity theory of money. Then came a series of supply shocks that made a shambles of the Phillips curve trade-off between inflation and unemployment, and the fine-tuning nostrums of orthodox, neoclassical Kennedy-Keynesians, as well as the steady-as-you-go monetary growth rule of the monetarists. Inflation was now linked with a chronic level of unemployment that made "stagflation" the faddish neologism of our time. The supply shocks started with the world-wide crop failures of 1972, quickly followed by the devastating 1973 OPEC crisis which had a shattering effect on growth and led to a rapid acceleration of the inflation rate. Lower levels of GNP were now associated with still higher price levels. These supply shocks were an addition to the inflationary bias built into the economy by the successful postwar stabilization policies of the government. "When an economy is made depression proof," according to Okun, "private expectations and conventions become asymmetrical, introducing an inflationary bias into the system" (Feldstein, p. 169). The underlying inflation rate of about 5 percent in the 1960s was, in retrospect, politically tolerable. Building on this basic inflation rate, the supply shocks pushed the economy into double-digit inflation at the same time that employment and economic growth were seriously depressed.

It is invariably during periods of great crisis, when conventional theoretical explanations no longer serve their legitimating roles, that the ground is laid for the rise of crackpots and assorted runaway ideologues with simple explanations for complex problems, designed explicitly for simple minds. This is the stuff of manipulated mass movements, particularly of a counterrevolutionary bent. Generally, a single cause is attributed to all of society's ills. And for single causes there are single solutions -- panaceas for piping us into the good society. It was the 1970s, and the inability of existing theories to cope with dramatic, unexpected, and unpredictable changes in the underlying structures of society that gave rise to the ideology of supply-side economics.

V

The role of established social theory is to legitimate the status quo and to serve those in power. But the status quo has been shattered. We are now in the midst of a new crisis of

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faith, and new theories are being devised to cope with a society in disarray. It is in times such as these that a new breed of ideological visionaries emerges which is prepared to sacrifice the present and the past in the name of a Utopian future -- even if it means an increase in human suffering and the sacrifice of the powerless and the disenfranchised on the way to that good society. Chiliasts have a long-run view. They are not known for their tolerance and forebearance in the short run or for their sensitivity to human suffering.

Supply-side theory is not new, nor is it revolutionary in the usual sense of that word. It is, if anything counter-revolutionary, a repudiation of the past, a desperate attempt to undo the last fifty years and to return to the prewar world of the 1920s. Supply-side theory has been lurking in the backwaters of economics for some time and would have remained there but for the election of Ronald Reagan. In those rare cases when backwater theories gain power, they are invariably corrupted by the need to consolidate that power. Praxis and theory are torn apart in the ensuing struggle. Purists demand that the 'revolution' be realized in its full dimension. Pragmatists advise caution and the tempering of theory in the face of political realities. To compound the problem, the theory itself splinters into warring camps with different factions at each other's throats.

Supply-side economics is not a coherent system of intellectual thought. It is a grab-bag of ill though out ideas. It has within it different strains based on different ideological antecedents. It is essentially conservative, if not reactionary. It represents a return to the economic theories of the 1920s based on "free" markets. It has little to learn from history. The past is not to be studied and interpreted; it is to be molded into theoretical compliance. It is to be rewritten and undone.

Reaganomics, as distinct from supply-side economics, is a general term covering basically three loosely allied groups, each with its own particular viewpoint. The only thing that unites them is a shared aversion to the liberal policies of the postwar period. Each gives conflicting advice to the President, and each jockeys against the others in the corridors of power.

A croporate organization chart of Reaganomics is shown below. There are three main groups. The first is the President's Advisory Council, consisting of old guard Republican conservatives who believe in cutting government expenditures and balancing the budget. Second, there is the Classical Supply-Side School under the putative leadership of Congressman Jack Kemp, but dominated by two former Wall Street Journal writers and the authors of the two basic books on supply-side economics. For this school, tax cuts are all and deficits, which unbalance the budget, are of secondary importance. Finally, the

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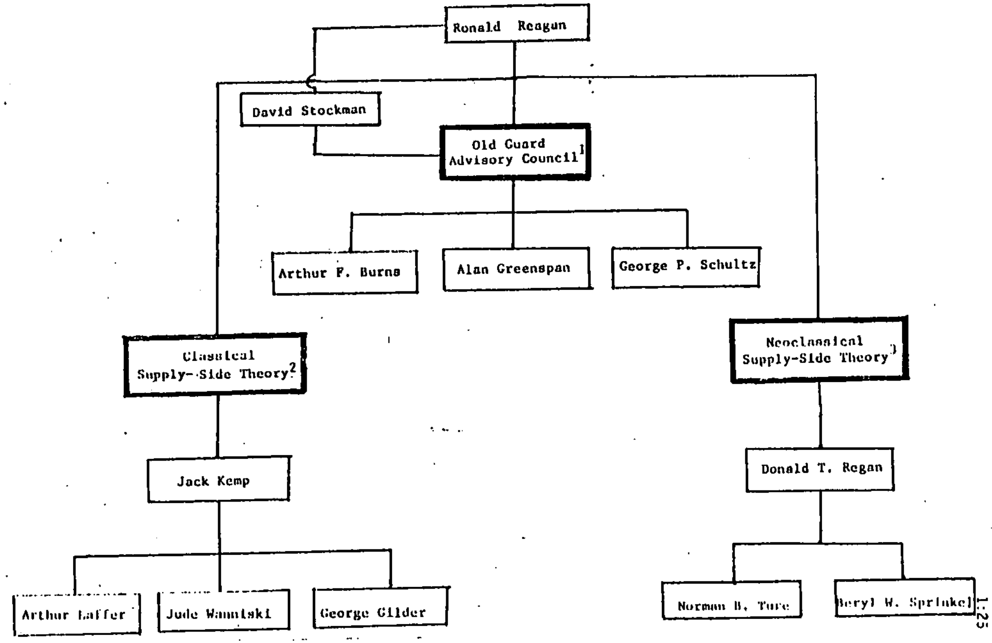

PROVENANCE: (1) Burns, Chairman, Council of Economic Advisors, and Chairman of the Board of Governors of the Federal Reserve System under Nixon; Greenspan, Chairman of the Council of Economic Advisors under Ford; Schultz, Secretary of the Treasury under Nixon: (2) Kemp, U.S. Congressman; Laffer, Economist; Wanniski, Wall Street Journal; Gilder, Wall Street Journal: (3) Regan, Secretary of the Treasury under Reagan; Ture, Under Secretary of the Treasury for Tax and Economic Policy under Reagan; Sprinkel, Under Secretary of the Treasury for Monetary Affairs under Reagan.

neoclassical-monetarist school is to be found in the Treasury Department under Donald Regan. Norman Ture and Beryl Sprinkel are followers of the Chicago School economist, Milton Friedman. For the classical school, tax cuts are everything, and monetarism is either dismissed as misguided or relegated to a secondary position. For the neoclassical school, control of the money supply is the key to all problems. And for the Advisory Council, the Federal budget must be balanced -- at all costs.

At this writing, it is not possible to predict which of the three will ultimately dominate. The chances are that Reaganomics will ignore the contradictions and borrow from all three simultaneously in varying combinations depending on which way the political winds are blowing.

Representative REUSS. Thank you. Mr. Shilling.

STATEMENT OF A. GARY SHILLING, PRESIDENT, A. GARY SHILLING & CO., INC., NEW YORK, N.Y.

Mr. SHILLING. Thank you, Congressman Reuss. I feel somewhat like that famous voice crying in the wilderness. I think you will see my concerns and views differ slightly from those of my academic colleagues on this panel.

POTENTIAL BENEFITS OF THE REAGAN PROGRAM DISCUSSED

The Federal income tax rate reductions and spending restraints that were enacted late last summer have sparked considerable debate over the effects of the total program, on income distribution of individuals. Our work indicates that income patterns are being changed by these tax and spending initiatives, but it also shows that without these changes, interest rates will probably remain high in the years ahead and sustainable economic recovery could be postponed indefinitely.

What is surprising about this, at least to us, is that during this period the Government policy was obviously redistributing income downward. I think we are all familiar with the mechanism. With a progressive individual tax system, this plus inflation has pushed people into higher tax brackets. Consequently, the Federal revenue collection has been a very efficient system. If there is anything I would have liked to have owned stock in the last 30 years, it is the Federal Government.

And then, of course, this income has been redistributed to lower income people via the various transfer payments.

INEQUALITY INCREASE PARTLY DUE TO INFLUX OF YOUNG WORKERS

Now this would have suggested that we would have expected to have seen a downward shift in income over this period, but offsetting this were a number of demographic factors. Specifically, we had a tremendous inflow of the postwar "baby boom" generation at the working and household formation ages, adding a large number of units with below-average incomes into the economic pie between 1960 and 1978. These people, in effect, helped in a statistical sense to push up those in the higher brackets. We were simply adding so many people at the bottom, that it looked as though income was moving upward from the demographic sense.

Table 2 shows the distribution of population, and shows very clearly how, in the last several decades this postwar baby generation was entering the 15 to 24 age bracket, and then the 25 to 34 age bracket.

We similarly had rapid growth in the number of single and female-headed households and of elderly households, which also swelled the number of lower income people. Now of course, this apparent demographic upward shift didn't really add any dollars to the incomes of upper income people, so the apparent shift was really a statistical mirage. In reality, the income shift has been downward through the Government policy actions.

In the current decade, however, the growth of the labor force would be much slower as the postwar baby bust members dominate the 15 to 24 age groups. Consequently, in the absence of policy changes, the momentum of past social welfare initiatives would clearly redistribute income downward by 1987, the terminal year we are using in our study. And that is shown in table 1. With the tax and spending savings from last summer, the income distribution by 1987 would be unchanged from earlier years. This is also shown on that table.

REAGAN PROGRAM WILL SHIFT INCOME TO THE RICH * * *

Now, if we move to tables 2 and 3, it clearly shows why the tax and spending restraints do have the impact of countering what would otherwise be a shift in income down.

The income categories are in 1980 dollars, and in that year about one-third of the households had income below $11,500; another third were between $11,500 and $22,900; and a third had incomes over $22,900.

Since the bulk of the income transfers are received by lower income groups, it is not surprising on tables 3 and 4, as we look at the effects of the new policy changes, that the bulk of the spending restraint is felt by these lower income groups, both for fiscal 1982 and 1983 as shown in table 3, and for fiscal 1982 through 1987, as shown in table 4.

Conversely, the bulk of the tax cuts are received by higher income households. Since these people pay most of the taxes, proportional cuts in tax rates, as under the new law, give them the largest tax savings and also the greatest increases in aftertax income, which is shown in table 6.

The net effect of the combined tax rate cuts and income restraints then, is to leave more aftertax dollars in the hands of the upper income people who earned them, rather than to tax them away to be redistributed to lower income households.

It should be remembered, of course, that no actual cuts from current levels of Federal tax receipts, or income transfer payments are envisioned in these policy changes. Both are certainly likely to increase in coming years. So the numbers we are examining here are merely reductions from what otherwise would be the case.

* * * BUT WILL ENCOURAGE SAVING AND INVESTING

Now, of course, one purpose of the tax and spending restraints is to let people keep more of the rewards of their efforts, and therefore to encourage productive investment. Perhaps an even more important result is the additional savings that will be produced even without assuming any additonal willingness to save, because of lower tax rates. This is simply true because upper income people are the big savers and lower income people the big spenders, as is shown very clearly in table 8 where we are examining the savings rates and spending rates by various income categories.

Households with over $47,800 in 1980 dollars gross income, tend to save 33 percent of their aftertax income on average. And at the other end of the spectrum, those with under $11,500 gross income, spend $1.37 for each $1 of after tax income they received. In other words, they have a negative saving rate of 37 percent. It is almost the exact antithesis of the higher income group.

Now people probably save more of each additional dollar than they do out of their total income. But, even using the average as opposed to a marginal savings rate, using the ones shown in table 8, the net effect of the program is to increase personal saving by $19 billion in fiscal 1982 and 1983, and $141 billion over the fiscal 1982 through 1987 period. In fiscal 1987 alone, the saving increase would amount to $46 billion, according to this program.

Now there are other factors that may increase saving in coming years. We certainly expect significant economic growth after the current recession, which should increase savings as individual incomes rise. We think that perhaps some of the losses in real estate and other tangible assets that are now going on, may increase saving out of current income as people strive to rebuild their net worth.

Lower income tax rates and saving incentives like the new IRA's should induce people to spend less and save more. In total we expect the saving rate to be significantly higher than 1981's 5.3 percent and to reach 6.5 percent in 1987.

This may seem like a significant improvement over recent performance, but it is certainly nothing to crow about. As you can see from chart 1, 6.5 percent is considerably below the 7-percent-plus average of the 1966 to 1975 period. It is reasonable to ask why, in the face of all these incentives to increase savings, in the result of this program do we still have a saving rate that is only 6.5 percent?

It is simply because there are some important offsets. The postwar babies are swelling the 25 to 44 age group in the current decade. And this is the age bracket when people spend heavily on cars, appliances, and other items related to new and growing households. Their income will be substantial, but their saving rate will be low, as shown in table 9; 35- to 44-year-olds tend to save only 4 percent compared to 11.4 percent average for the 1972–73 consumer expenditure survey on which this data was originally based.

And of course, the postwar babies, the 1960's generation, if you will, because of their attitudes in the past, may save even less.

The saving rate is also likely to be depressed by the tremendous borrowing we expect in the years ahead as consumers finance the big "catchup" in auto sales that we are looking for, and of course appliances and household furnishings are likely to boom as a result of the explosion in housing that we think is necessary to house the postwar babies.

We estimate that all these factors will lower the saving rate by about 1 percent from what it otherwise would have been. In effect then, the economic policy changes and other inducements are needed to keep the saving rate from slipping below a level that is already low by historical standards.

As the queen, in "Through the Looking Glass" said, "it takes all the running you can do to keep in the same place."

THE FINANCING SQUEEZE AND HIGH INTEREST RATES

Now, one might ask why is even a 6.5-percent saving rate necessary in coming years?

Well, it is simply necessary to supply the likely demand for funds, including the financing of the Federal deficit. Table 10 illustrates some of the strength we see in the economy and the private sector, and autos in particular. I have already discussed those briefly, but we do think housing starts by 1987 could reach 2.6 million compared to 1.1 million last year.

The financing increases associated with this more than doubling in housing is clear. Auto sales including imports may almost double by 1987, again calling for many more funds to finance them.

Capital spending may not be uniformly robust in the years ahead, despite the new tax incentives and the expected lowering of interest rates. But a number of significant areas are likely to expand rapidly, including labor-saving equipment. As shown in table 11, the total labor force is likely to grow much more slowly in the next 10 years.

As noted there in both fiscal 1982 and 1983, and even in fiscal 1987, we still have a shortfall of funds relative to the demand. Obviously, Federal deficits of another $20 or $30 billion or even more above what the administration predicts will show a real squeeze on financial markets. We could see interest rates remaining at high levels, and the economic expansion we all hope is going to follow the current recession could be pretty much precluded.

Now, reduced savings, of course, would have the same effect as increased deficits. And it is worth noting that by 1987 each 1-percent decline in the saving rate would reduce the supply of funds by about $35 billion. It may be small by Federal standards, but I think we all could comfortably retire on that amount.

RESCINDING THE INCOME TAX CUT WOULD REDUCE SAVING

One might argue, of course, that the easy way to reduce the Federal deficit and ease the supply-demand balance for funds, is to simply rescind part of the scheduled individual tax rate cuts. After all, if these cumulate to $750 billion over the fiscal 1982 to 1987 period as was shown back on table 4, why not cut out a mere $50 billion in 1987 and balance the budget, as well as increase the supply of funds well above the demand?

Table 14 shows in alternative A, that this would reduce the deficit by $50 billion, all right, this idea of simply rescinding $50 billion in the tax cut. But it would largely be at the expense of savings. Higher income people who would be hit hardest by the ending of this portion of the tax cut, would probably alter their consumption very little and take most of the relative income—I'm sorry, much of the relative increase in taxes out of their savings.

Lower income people, of course, pay very little taxes and save even less. So even though a relative tax increase would probably reduce their consumption somewhat, the overall effects would be small.

On balance, our calculations showed that this essentially would be a tax saving of $36 billion, savings that otherwise would go to finance the deficit. In other words, the tax cut is definitely skewed to the higher end. So if you rescind part of that tax cut, it becomes much more a tax on saving than anything else. And, of course cutting the deficit by $50 billion doesn't do you much good if, in effect, all you have done is reduce saving by $36 billion, leaving a net addition to the capital markets of only $14 billion. This is, obviously, clearly a very inefficient way of reducing the strains on capital markets and hence insuring a lower interest rate.

PROPOSAL FOR A CONSUMPTION TAX

A much better way to reduce both the deficit and the pressure on financial markets is to cut Government spending or to add some sort of tax on consumption. A $50 billion consumption tax which we examined in alternative B, would only reduce savings by $26 billion, even though we assume that upper income people would pay for it entirely out of savings, and that they wouldn't change their consumption patterns at all.

The reason that we have no more than this $26 billion decline in savings, is because these upper income people have high incomes, but they also save so much that their total consumption—which of course would be the subject of consumption tax—is less than the total consumption of low income people. The latter group would probably reduce their total consumption by the full extent of the tax.

On balance then, a $50 billion consumption tax also reduces the deficit by $50 billion. But in this case savings are cut by only about half of that, $26 billion, and the net gain in the supply of funds is $24 billion.

Now, I'm fully aware that a tax on consumption may sound cruel, and it is probably politically very difficult because of its effects on low-income people. But, it should be remembered that many of these people should be moving to higher income levels in future years.

If successful, the new tax and spending restraints should reduce Government's share of the economic pie and supply enough savings to come at least close to balancing demand.

These, and other factors in our judgment, could well lead to significantly lower inflation and lower interest rates, meaningful productivity improvements, and consequently sustainable economic growth that could propel many households into higher income categories.

As shown in table 15, between 1980 and 1987, when 10.1 million households are expected to be formed, an additional 9.4 million households will be moving into the $22,900 gross income or over category as a result of income growth and demographic factors.

In contrast, during the 1967 to 1980 period, only 9.1 million households moved into that category out of a total increase of 19.6 million, only about half of them. In terms of household incomes, old and new, 43 percent would have incomes of $22,900 or more in 1980 dollars by 1987, compared with 37 percent in 1980, and 34 percent in 1967.

Overall then, the new tax rate cuts and spending restraints may appear to leave more income in the hands of upper income households at the expense of lower income people. But without these policy changes we doubt that savings would be adequate to finance the exciting expansion we see beyond the current recession, an expansion that holds the promise of fulfilling many pentup demands in the private sector.

Lower income people might appear to end up with less than they otherwise might, but inadequate saving and the resulting continuation of high interest rates would almost certainly abort the business expansion and productivity improvements that are probably the only feasible way of significantly improving the income and purchasing power of these lower income people. Thank you.

[The prepared statement of Mr. Shilling follows:]

PREPARED STATEMENT OF A. GARY SHILLING

The Federal income tax rate reductions and spending restraints that were enacted last summer have sparked considerable debate over the effects of the total program on the income distribution of individuals. Our work indicates that income patterns are being changed by these tax and spending initiatives, but it also shows that without these changes, interest rates will probably remain high in the years ahead and sustainable economic recovery could be postponed indefinitely.

Table 1 shows that historically there has been little change in income distribution in this country. Between 1960 and 1978, the fractions of aftertax income, including transfer payments, received by the upper, middle, and lower thirds of households in the distribution hardly changed. This is surprising since during that period government policy was obviously redistributing income downward. We're all familiar with the mechanism. With a progressive individual income tax system, inflation was pushing people into higher tax brackets. The tax system became a very efficient machine for converting surging inflation into Federal revenues which were then transferred to lower income people via welfare, unemployment insurance, and other transfer payments.

Offsetting this redistribution policy, however, were a number of demographic factors. Specifically, the arrival of the "baby boom" generation at the working and household formation ages added a large number of units with below-average incomes into the economic pie between 1960 and 1978. Table 2 shows the rapid growth in the 15-24 and 25-34 age groups during that period. Similarly, rapid growth in the numbers of single and female-headed households and of elderly households swelled the numbers of lower income people.

TABLE 1

DISTRIBUTION OF AFTERTAX INCOME
INCLUDING TRANSFER PAYMENTS

	1960	1978	1987 Without New Programs	1987 With New Programs
Fraction of Households:				
Upper 1/3	54.3%	54.1%	50.9%	54.9%
Middle 1/3	29.0%	28.8%	29.7%	28.2%
Lower 1/3	16.7%	17.1%	19.4%	16.9%

Source: IRS, Statistics of Income, 1960 & 1978
Dept. of Commerce, Bureau of the Census, Consumer Income Reports, 1960, 1978
A. Gary Shilling & Company, Inc. estimates.

TABLE 2

AVERAGE ANNUAL RATE OF GROWTH IN POPULATION BY AGE
(1950-2000)

	1950-1960	1960-1970	1970-1980	1980-1990	1990-2000
	----------	% Annually	----------		
Total	1.7%	1.3%	1.0%	0.7%	0.7%
Under 15 Years	3.2	0.3	(1.5)	1.0	0.3
15-24	1.0	4.0	1.3	(1.8)	0.5
25-34	(0.5)	1.0	3.6	1.3	(1.7)
35-44	1.1	(0.5)	1.1	3.6	1.2
45-54	1.6	1.3	(0.3)	1.1	3.5
55-64	1.6	1.8	1.3	(0.2)	1.1
65 +	3.0	1.9	2.2	1.8	0.7

Source: Bureau of the Census

The bottom line impact of these additions was the dilution of income share at the lower end and a consequent shift in the distribution of gross income toward the upper end. Of course, this shift didn't actually add any dollars to the incomes in the upper strata, so the apparent upward shift caused by demographics is really a statistical mirage. In reality, the income shift has been downward due to government policy actions.

In the current decade, however, the growth in the labor force will be much slower as the postwar baby bust members dominate the 15-24 age groups. Consequently, in the absence of policy changes, the momentum of past social welfare initiatives would clearly redistribute income downward by 1987, as shown in Table 1. With the tax and spending changes begun last summer, however, the income distribution in 1987 would be about unchanged from earlier years.

Tables 3 and 4 show why. The income categories are in 1980 dollars, and in that year about 1/3 of the households had income below $11,500, 1/3 between $11,500 and $22,900, and 1/3 over $22,900. Since the bulk of income transfers are received by lower income groups, it is not surprising that the bulk of spending restraint is felt by these groups, both for fiscal 1982 and 1983 and for fiscal years 1982 through 1987. Conversely, the bulk of the tax cuts are received by higher income households. Since these people pay most of the taxes, proportional cuts in tax rates, as under the new law, give them the largest tax savings and also the greatest increases in aftertax income as shown in Table 6.

The net effect of the combined tax rate cuts and income restraints, then, is to leave more aftertax dollars in the hands of the upper income people who earned them

TABLE 3

DISTRIBUTION OF INDIVIDUAL TAX CUTS AND TRANSFER PROGRAM REDUCTIONS
($ BILLIONS)

CUMULATIVE FISCAL YEARS
1982 - 1983

	Household Income				
	Lower	Lower-Middle	Upper-Middle	Upper	
	(<$11,500)	$11,500-($22,900)	$22,900-($47,800)	($47,800 +)	Total
Transfer Program Reductions	($11.0)	($19.1)	($12.4)	($3.5)	46
Tax Cuts	$3.8	$17.9	$40.7	$41.6	104
Net Effect	($7.2)	($1.2)	$28.3	$38.1	58

(Household income in 1980$; all other figures in current $)

Sources: U.S. Department of Treasury
Office of Management & Budget
A. Gary Shilling & Company, Inc. estimates

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TABLE 4

DISTRIBUTION OF INDIVIDUAL TAX CUTS AND TRANSFER PROGRAM REDUCTIONS
($ BILLIONS)

CUMULATIVE FISCAL YEARS
1982 - 1987

	Household Income				
	Lower (<$11,500)	Lower-Middle $11,500-($22,900)	Upper-Middle $22,900-($47,800)	Upper ($47,800 +)	Total
Transfer Program Reductions	($58.5)	($98.4)	($79.0)	($23.1)	(259.0)
Tax Cuts	$24.6	$109.7	$299.3	$315.8	749.4
Net Effect	($33.9)	$11.3	$220.3	$292.7	490.4

(Household income in 1980$; all other figures in current $)

Source: U.S. Department of Treasury
Office of Management & Budget
A. Gary Shilling & Company, Inc. estimates

TABLE 5

PERCENT DISTRIBUTION OF TRANSFER PROGRAMS BY GROSS INCOME LEVEL OF HOUSEHOLD 1978

	Direct Income Transfers (%)	Non-Cash Transfers (%)
Total Transfers:	100.0%	100.0%
Lower Income (<$11,500)	37.7	74.0
Lower Middle ($11,500-$22,900)	31.7	16.1
Upper Middle ($22,900-$47,800)	24.9	9.9
Upper ($47,800 & Over)	5.7	----

(Income levels in 1980$)

Note: In general, the transfer program cuts are distributed according to the distribution of benefits. In the case of programs requiring means test, i.e., food stamps, Medicaid, etc., the cuts are distributed in accordance with the administration's stated intention of removing upper and middle income households from the programs.

TABLE 6

EFFECT OF TAX PROGRAM ON AFTER-TAX INCOME AT VARIOUS INCOME LEVELS

Adjusted Gross Income ($)	Taxable Income[1] ($)	Old Law: Marginal Rate (%)	Old Law: After-Tax Income ($)	New Law: Marginal Rate (%)	New Law: After-Tax Income ($)	Change in After-Tax Income: $ Change ($)	Change in After-Tax Income: % Change (%)	Change in After-Tax Income Incl. S.S. Increase[2] (%)
10,000	6,000	16%	9,450	12%	9,577	127	1.3%	0.8%
20,000	15,400	26%	17,420	20%	18,026	606	3.5%	3.0%
30,000	23,100	31%	25,173	24%	26,290	1,117	4.4%	2.9%
40,000	30,800	42%	32,301	32%	34,123	1,822	5.6%	2.9%
50,000	38,500	46%	38,891	35%	41,527	2,636	6.7%	4.6%
70,000	53,900	54%	51,071	41%	55,585	4,514	8.8%	7.3%
90,000	69,300	59%	62,320	45%	68,923	6,603	10.5%	9.4%
110,000	84,700	63%	73,118	48%	81,906	8,788	12.0%	11.0%
210,000	161,700	70%	121,930	50%	143,948	21,948	18.0%	17.5%

Based on Head-of-Household filing status, four-person family

[1] Assumes standard deduction for incomes under $20,000 and deductible expenses equal to 23% of Adjusted Gross Income (AGI) for higher incomes.

[2] Assumes 8% annual inflation adjustment in maximum taxable earnings between 1981 and 1984.

Source: Department of the Treasury

TABLE 7

ESTIMATED 1980 DISTRIBUTION OF TAXPAYERS

Adjusted Gross Income	Number of Returns (millions)	Percent of Tax Returns	Percent of Taxes Paid
$ 10,000	36.0	39.0%	5.0%
$ 10-$20,000	21.5	23.5%	21.6%
$ 20-$30,000	19.5	21.0%	25.0%
$ 30-$50,000	12.5	13.5%	22.7%
$ 50-$100,000	2.5	2.5%	12.9%
$100,000 +	0.5	0.5%	12.8%
	92.5 million	100.0%	100.0%

Note: Tax reductions are distributed according to the distribution of tax liability projected for 1982 and 1987. These projections reflect shifts in the distribution of income resulting from demographics and real income growth.

Source: IRS, Statistics of Income, 1978
A. Gary Shilling & Company, Inc. estimates

rather than tax them away to be redistributed to lower income households. It should be remembered, of course, that no actual cuts from current levels in Federal tax receipts or income transfer payments are envisioned in these policy changes. Both should increase in coming years, and the numbers shown in Tables 3 and 4 are merely reductions from what otherwise would have been the case.

One purpose of the tax and spending restraints is to let people keep more of the rewards of their efforts and therefore to encourage productive investment. Perhaps a more important result is the additional savings that will be produced, even without assuming any additional willingness to save, because of lower tax rates. Upper income people are the big savers and lower income people the big spenders, as shown in Table 8. Households with over $47,800 in 1980 dollars gross income save 33% of their aftertax income on average. At the other end of the spectrum, those with under $11,500 gross income spend $1.37 for each dollar of aftertax income -- a negative saving rate of 37%.

People probably save more of each additional dollar than they do of their total income. But even using the average saving rates shown in Table 8, the net effect of the program is to increase personal saving by $19 billion in the fiscal 1982-83 period and $141 billion, over the fiscal 1982-87 years. In 1987 alone, the saving increase would be $46 billion. Other factors may increase saving in coming years. The significant economic growth we expect after the current recession should also increase saving as individual incomes rise. Losses on real estate and other tangible assets may increase saving out of current income as people strive to rebuild their assets. Lower income tax rates and saving incentives like the new IRA's should induce

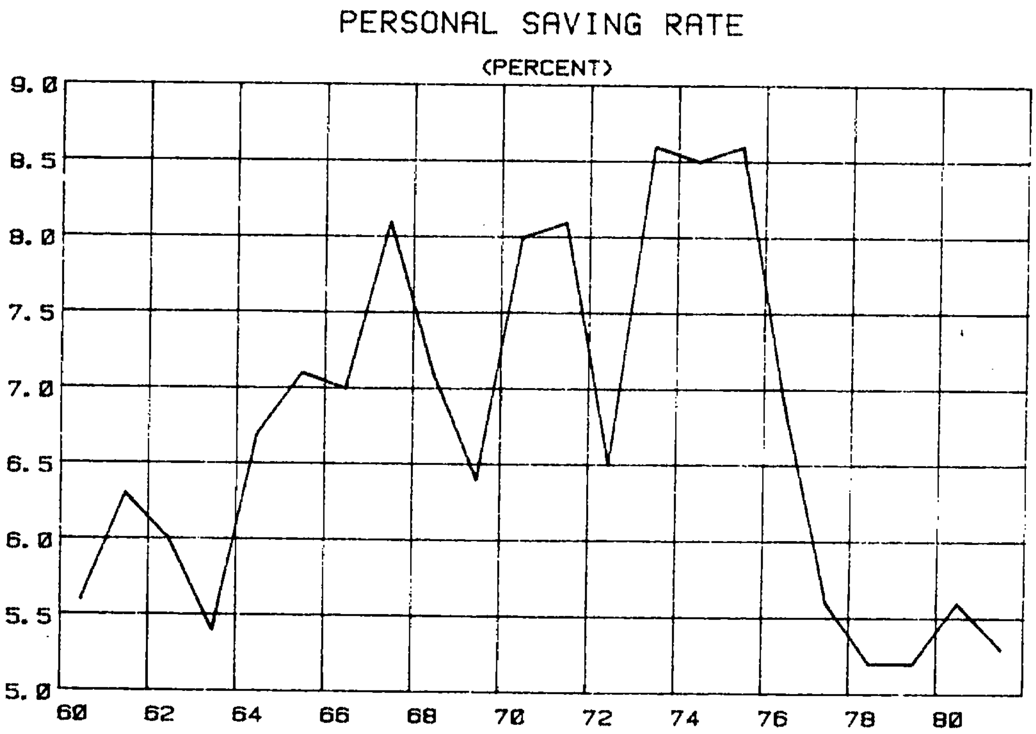
TABLE 8

ESTIMATES OF CONSUMER SPENDING/SAVING
BY GROSS INCOME LEVEL

Gross Income (1980$)	% of Aftertax Income Used for: Consumption (%)	Saving (%)
Under $11,500	136.7	(36.7)
$11,500-$22,900	98.6	1.4
$22,900-$47,800	85.6	14.4
$47,800 & Over	67.4	32.6

Note: Data derived from 1972/1973 Consumer Expenditure Survey, collected by the Bureau of Labor Statistics. Rates subsequently reconciled with N.I.P.A. figures through 1980.

CHART 1


PERSONAL SAVING RATE
(PERCENT)
9.0
8.5
8.0
7.5
7.0
6.5
6.0
5.5
5.0
60
62
64
66
68
70
72
74
76
78
80

people to spend less and save more. In total, we expect the saving rate to be significantly higher than 1981's 5.3% and to reach 6.5% in 1987.

This may be a significant improvement over recent levels, but it's nothing to crow about. As Chart I shows, 6.5% is considerably below the 7%+ average of the 1966-75 period. Why, in the face of all this increased saving, don't we foresee a bigger rise in the saving rate? Because there are offsets. The postwar babies are swelling the 25-44 age group in the current decade -- the age bracket in which people spend heavily on cars, appliances, and other items related to new and growing households. Their incomes will be substantial, but their saving rate should be low. As shown in Table 9, 35-44 year olds tend to save only 4% compared to the 11.4% average for the 1972/73 Consumer Expenditure Survey, and the postwar babies -- the "1960's generation" -- may save even less.

The saving rate is also likely to be depressed by the tremendous borrowing we expect in the years ahead as consumers finance the likely catchup surge in auto sales, and the appliance and household furnishings boom that would accompany the residential construction explosion needed to adequately house the postwar babies. We estimate that these factors will lower the saving rate by about 1% from what it otherwise would have been. In effect, the economic policy changes and other inducements are needed to keep the saving rate from slipping below a level that is already low by historical standards. As the Queen in Through the Looking-Glass said, "it takes all the running you can do, to keep in the same place."

But why is even a 6.5% rate of saving necessary in coming years? Simply to supply the likely demand for funds, including the financing of the Federal deficit. Table 10 illustrates the catchup demand in autos and housing that I already mentioned.

TABLE 9

ESTIMATES OF HOUSEHOLD SPENDING/SAVING BY AGE

	% of After-Tax Income Used For:	
	Consumption	Saving
Under 25 years	112%	(12%)
25-34 years	96	4
35-44 "	96	4
45-54 "	90	10
55-64 "	88	12
65 & over	94	6

Note: Data derived from 1972/1973 Consumer Expenditure Survey, collected by Bureau of Labor Statistics. Rates subsequently reconciled with N.I.P.A. figures through 1980.

We foresee housing starts at 2.6 million in 1987 compared to 1.1 million last year. The financing increases associated with this more than doubling are clear. Auto sales, including imports, may almost double by 1987, again calling for many more funds.

Capital spending may not be uniformly robust, despite the new tax incentives and the expected lower interest rates, but a number of significant areas are likely to expand rapidly, including labor-saving equipment. As shown in Table 11, the total labor force is likely to grow much slower in the next ten years compared to the last ten. Better economic conditions should reduce the flow of women entering the labor force, and the postwar baby bust phenomenon will result in an actual decline in the 15-24 age group. As a result, a surge in labor-saving equipment and productivity-enhancing equipment spending will be necessary to avoid labor shortages.

In determining the size of the Federal budget deficit, we feel that the Administration has been a bit optimistic in their new economic projections. As shown in Table 12, we see less economic growth over the 1982-87 period. In particular, we look for a weaker economy this year and next than the Administration and have built in a recession in 1986 -- we don't think recessions are extinct. Our slower growth pattern would imply larger deficits than just announced. To be conservative however, we are basing the Federal deficits in Table 13 on the Administration's projections.

You will note that even with lower Federal deficits than may occur and with all the increased saving resulting from the tax rate cuts and spending restraints, we still expect the demand for funds to exceed the supply in fiscal 1982, 1983 and even 1987. Obviously, Federal deficits of $20-30 billion more in any of these years could severely crowd financial markets, keep interest rates at high levels, and prohibit the economic expansion we all hope for. Reduced saving would have the same effect,

TABLE 10

OUTLOOK FOR CONSUMER DEMAND FOR HOUSING & AUTOS
(MILLIONS OF UNITS)

	------- Housing --------		
	Starts	Mobile Home Shipments	Total Auto Sales
1979	1.7	.2	10.6
1980	1.3	.2	9.1
1981	1.1	.2	8.5
1982	1.0	.3	8.7
1983	1.5	.3	10.4
1984	2.1	.4	12.2
1985	2.4	.4	13.4
1986	2.2	.3	12.0
1987	2.6	.4	14.0

A. Gary Shilling & Company, Inc. estimates

TABLE 11

LABOR FORCE GROWTH
(1970-1990)

	Average Annual Percent Change	
	1970-1980	1980-1990
Total Civilian Labor Force	2.4%	1.7%
Working Women Aged 20+	3.7%	2.7%
Population Aged 15-24	1.3%	-1.8%

Sources: U.S. Department of Commerce, Bureau of the Census
U.S. Department of Labor, Bureau of Labor Statistics
A. Gary Shilling & Company estimates

TABLE 12

ECONOMIC ASSUMPTIONS
(ANNUAL AVERAGE PERCENT CHANGE)

	1982	1983	1984	1985	1986	1987	1987 Level ($ billion)
NOMINAL GNP							
OMB	8.1	11.5	10.2	9.7	9.2	9.0	5067.8
AGS & Co.	7.7	9.8	12.9	9.8	4.7	11.3	4986.1
REAL GNP (1972$)							
OMB	0.2	5.2	4.9	4.8	4.4	4.3	1904.5
AGS & Co.	0.0	3.3	5.0	4.0	0.5	5.0	1795.5
IMPLICIT PRICE DEFLATOR (1972=100)							
OMB	7.9	6.0	5.0	4.7	4.6	4.5	266.1
AGS & Co.	7.6	6.2	6.0	5.6	4.2	5.0	277.1

Source: Office of Management & Budget
A. Gary Shilling & Company, Inc. estimates

TABLE 13

SAVING AND INVESTMENT
(FISCAL YEAR)

(BILLIONS OF CURRENT DOLLARS)

	1981	1982	1983	1987
Net Demand for Investment Funds				
Plant & Equipment Investment	319	343	377	551
Residential Construction	110	96	112	220
Less: Depreciation Allowances				
Owner-Occupied Homes	-51	-58	-65	-106
Business & Non-Profit Organizations	-246	-262	-284	-362
Inventory Investment	10	8	9	44
Government Deficit (+) or Surplus (-) (NIA Basis)				
Federal	54	100	102	45
State & Local	-37	-15	0	5
TOTAL DEMAND	159	212	251	397
Supply of Investment Funds				
Personal Savings	100	130	147	226
Retained Earnings (with IVA)	65	57	86	152
Net Foreign Investment	-4	-5	-8	-10
TOTAL SUPPLY	161	182	225	368
Statistical Discrepancy	-2	0	0	0
Net Shortfall	0	-30	-26	-29

and it is worth noting that in 1987, each 1% decline in the saving rate would reduce the supply of funds by about $35 billion.

One might argue, of course, that the easy way to reduce the Federal deficit and ease the supply-demand balance for funds is to simply rescind part of the scheduled individual tax rate cuts. After all, if these cumulate to $750 billion over the fiscal 1982-87 period, as shown on Table 4, why not cut out a mere $50 billion in 1987 and balance the budget as well as increase the supply of funds well beyond the demand?

Table 14 reveals in Alternative A that this would reduce the deficit by $50 billion, but largely at the expense of saving. Higher income people, who would be hit hardest by the rescension, would probably alter their consumption little and take most of the relative increase in taxes out of saving. Lower income people pay little in total taxes and save less, so even though a relative tax increase would probably reduce their consumption somewhat, the overall effects would be small. On balance, our calculations showed this to essentially be a tax on saving of $36 billion, savings that would otherwise go to finance the deficit. Consequently, the net increase in available funds would only be $14 billion. A tax on saving is clearly inefficient.

A much better way to reduce both the deficit and the pressure on financial markets is to cut government spending or to add a tax on consumption. A $50 billion consumption tax, shown in Alternative B, would only reduce saving by $26 billion even though we assume that upper income households pay for it entirely out of saving and don't change their consumption at all. The reason is that these people have high incomes but they save so much that their total consumption -- the subject of the tax -- is less than the total consumption of low income households. The latter group would probably reduce their total consumption by the full extent of the tax. On balance, a $50 billion consumption tax also reduces the deficit by $50 billion, but savings are cut by only $26 billion and the net gain in the supply of funds is $24 billion.

TABLE 14

ALTERNATIVE MEASURES TO REDUCE 1987 BUDGET DEFICIT

ALTERNATIVE A: Rescind $50 billion of Personal Tax Cuts:

Decrease in Deficit	$50 billion
Change in Savings	($36 billion)
Increase in Available Funds	$14 billion

ALTERNATIVE B: Raise $50 billion in Consumption Tax:

Decrease in Deficit	$50 billion
Change in Savings	($26 billion)
Increase in Available Funds	$24 billion

Source: A. Gary Shilling & Company, Inc. estimates

A tax on consumption may sound cruel and is probably politically difficult because of its effects on low income people, but it should be remembered that many of them should move to higher income levels in future years. If successful, the new tax and spending restraints should reduce government's share of the economic pie and supply enough saving to come close to balancing demand. These and other factors could well lead to significantly lower inflation and interest rates, meaningful productivity improvement, and, consequently, sustainable economic growth that would propel many households into higher income categories.

As shown in Table 15, between 1980 and 1987, when 10.1 million households are expected to be formed, an additional 9.4 million households will be moving into the $22,900 and over category as a result of income growth and demographic factors. In contrast, during the 1967-80 period, only 9.1 million households moved into that category out of a total increase of 19.6 million. In terms of total households -- old and new -- 43% would have incomes of $22,900 or more in 1980 dollars by 1987 compared with 37% in 1980 and 34% in 1967.

Overall, then, the new tax rate cuts and spending restraints may appear to leave more income in the hands of upper income households at the expense of lower income people. Without these policy changes, however, we doubt that savings would be adequate to finance the exciting expansion we see beyond the current recession, an expansion that holds the promise of fulfilling many pent-up private sector demands. Lower income people might appear to end up with less than they otherwise might, but inadequate saving and the resulting continuation of high interest rates would almost certainly abort the business expansion and productivity improvements that are probably the only feasible way of significantly improving the income and purchasing power of these people.

TABLE 15

GROWTH IN HOUSEHOLDS BY GROSS INCOME
1967 - 1987

	1967-1980		1980-1987	
	----- millions of households ---------			
	Total	Per Year	Total	Per Year
Increase in Households:				
Total	19.6	1.5	10.1	1.4
Incomes Under $22,900	10.5	0.8	0.7	0.1
Incomes $22,900 & Over	9.1	0.7	9.4	1.3

$22,900 & Over as Percent of Total Households:

1967	34.2%
1980	37.2%
1987	43.4%

(income in 1980 $)

Sources: U.S. Department of Commerce, Bureau of the Census
A. Gary Shilling & Company, Inc. estimates

Representative REUSS. Thank you, Mr. Shilling. And finally, Mr. Smith.

STATEMENT OF JAMES D. SMITH, PROFESSOR, INSTITUTE FOR SOCIAL RESEARCH, UNIVERSITY OF MICHIGAN, ANN ARBOR, MICH.

Mr. SMITH. I have been asked to address three broad areas related to the distribution of income and wealth: The recent trends in the distribution and the causes; the impact of President Reagan's policies on the distribution; and third, what should be done to lessen inequality or prevent it from increasing.

I have tried to address all these issues in my prepared statement, and in my spoken comments this morning I will just briefly review what we know about the trends in the concentration of wealth, the distribution of wealth, and then turn my attention to how I think the administration's policies, both with respect to taxation and in an overall sense, will affect the distribution of wealth.

POOR DATA ON WEALTH DISTRIBUTION

Within the area of the distribution of wealth, I think that I am now engaged in a situation in which the blind are leading the blind. If I have any advantage over you, it's only because I have been tapping by cane a bit more vigorously and a little bit more enthusiastically, feeling along for the walls that mark the outer perimeter of that darkness.

There is simply very little data that would allow us to assess the distribution of wealth at a point in time or as changes over time. They certainly would reinforce Professor Budd's earlier comments with respect to the administration's policies regarding the reduction of social intelligence. It seems that the administration is embarked on a course of action to destroy the eyes and ears of society through cuts to the Census Bureau, cuts to the National Science Foundation. Particularly those with respect to economic intelligence I think will have a devastating effect on our ability to conduct enlightened public policy in the years ahead.

We certainly have done very little in the past to develop an understanding of how wealth becomes concentrated the way it does and even to understand what that distribution looks like.

The last serious effort in this area by the Federal Government at least, I think, was conducted in 1962 by the Board of Governors of the Federal Reserve System.

We have had no effort, no successful effort, to measure wealth distribution since then. The Ford Foundation and the National Science Foundation have made rather valiant efforts in the years to fund small pieces of work that might put us in a position to at some time engage in a serious study for the distribution of wealth.

As you will recall, in the early 1960's, this committee, in conjunction with some efforts of the Ford Foundation, embarked on a small-scale study called Measuring the Nation's Wealth. It was a brief and aborted effort, but nevertheless about all we can say is that's been done.

RECENT TRENDS IN THE DISTRIBUTION OF WEALTH

Now, what have been the trends in the distribution of wealth? That question specifically was asked of me. It is well within the society's technical ability to produce these answers, the answer to this question, but we haven't. And we haven't for the reasons I've just mentioned.

The best I can do for you is to piece together some fragmentary evidence that comes from a large number of sources. I will try to give you some sense of what has happened with the distribution of wealth over the course of the history of this Nation and particularly over the last few decades.

Rather diligent efforts by a large number of scholars, when put together, suggest that the distribution of wealth in the United States was most equally distributed in the colonial and post-Revolutionary War period. From that point forward, with the exception of a period around the Civil War and around World War II, there was a rather gradual increase in wealth concentration in the United States. It reached a high point of concentration in about 1929 and then declined, through the Great Depression and through World War II.

There then ensued a period of relatively constant or stable economic stratification, with a slight bit of evidence that perhaps by 1969—the measurements I made—that there might have been some movement toward greater equality.

However, in estimates I subsequently made in 1972, the 1969 movement toward equality was called into question as perhaps being more of a statistical artifact than a real downward trend in the concentration of wealth.

In any event, current work going on at the University of Michigan suggests that at least the creme de la creme of the rich, the very top of the distribution, the top one-half of 1 percent, may have lost some of their share of the Nation's total wealth it held in all the past measurements of the last two decades.

Now, one should be very cautious in interpreting that. Simply saying that the top one-half of 1 percent, that very tip, had a decline in their share of the Nation's total personal wealth that it used to hold doesn't mean there has been a great deal of change in the distribution. We don't know where that went.

If it simply went down a few percentiles, so that the redistributon was from the superrich to the nearly superrich, it has hardly any economic or social significance.

Unfortunately, because we have not concerned ourselves with building intellectual capital in this area, we don't know anything about the rest of the distribution once we get down below the top 4 or 5 percent. We see it only very, very vaguely, through very imperfect survey measurements. And those measurements do very badly when we get up to the upper 20 percent.

If you would turn to the chart in my prepared statement, you can see the trend in the concentration of wealth for the top one-half of 1 percent, the richest one-half of 1 percent of the population, from about 1922 to 1976.

My comments of just a moment ago with respect to this 1976 measurement are related to that sharp decline that you will see at the very right-hand part of that graphic representation.

It's too early to tell what that means. But even if it's real, and it's not a statistical artifact, it is only a loss in the share of the wealth held by the top one-half of 1 percent. And where it went is the interesting question that we eventually would hope to answer.

EFFECT OF REAGAN POLICIES ON WEALTH DISTRIBUTION

Well, let me turn to the administration's policies with respect to wealth, And, of course, here we do not have the benefit of empirical data, and we won't for a long time. But we can conclude a lot by the deductive processes about what has to happen, what is most likely to happen if we take the policies a policy at a time, and not try to examine all interactions that might occur.

There is widespread agreement with respect to tax policies that the policies initiated by the administration in the tax law revision will be beneficial to the rich. The idea that we have a death tax in the United States which somehow or another reduces great concentrations of wealth is an erroneous one. We have never had a death tax that did that. We've had a death tax, but a rather defective one as far as reducing inequality because it was shot through with loopholes. And the rich were able, through the use of trusts and other devices, to move large masses of wealth from generation to generation.

What the Reagan administration has done is to further reduce any efficacy that tax might have had. I do not think that the administration's changes in the estate tax will have any serious effect on the concentration of wealth, simply because the previous estate tax that we had was, itself, ineffective. It represents more of a philosophical thrust than it does a changed policy that will have consequences for the distribution.

With respect to changes in the income taxes on individuals, the major changes have been to lessen the burden on the rich more than on the nonrich. Even in the classified ads of small town newspapers, one reads copy extolling the reader to seek tax shelters of various kinds, buy an apartment building, write it off in 15 years, no matter that it will last a hundred years—or don't write it off, don't keep it 15 years, keep it 5 years, sell it, take the capital gain, pay the preferential rate, and let the new owner start the process over again. Exclude the first $200 of dividends, the first $1,000 of interest from an all-savers certificate, buy municipal bonds, pay zero taxes on the interest. Buy a tax-deferred retirement annuity if you are a college professor, then put additional $2,000 into an IRA and exempt that also—or defer from that the current interest.

These provisions in tax law—these revisions in the tax law leave low-income, working people out in the economic cold. The tax laws prior to this administration were preferential enough to the owners of property. What will be the impact of the administration's overall program?

I think it is important to distinguish between the avowed goals of the administration and the strategies it is using to achieve those goals. The avowed goals—or at least the major ones, as I discern some of them which are quite explicitly made by the administration—are to improve the performance of the supply side of the market, to reduce Government waste and inefficiency, to enhance the Nation's military capability, to free the market from Government shackles, and to move toward a balanced budget. The latter is apparently no longer a goal of the administration.

Well, let me turn to these. Clearly, I might say that eliminating waste in the Federal Government is the most popular topic of political elocution in the history of mankind. It was popular in the last election when it was a Democratic issue—as a Republican issue, it will be popular again in a year—approximately a year, when it will become a Democratic issue, in which we will again proceed to eliminate waste, inefficiency, and fraud in Government.

I can only conclude that neither political party is very efficient at getting this done, since it appears every 2 years at least as an issue of great concern.

Nevertheless, we ought to cut out fat wherever we find it. Mr. Stockman has assured us of that. But in pursuance of that goal, I think we should be careful that the butcher not be blind, lest he cut the marrow or emasculate himself in the public press.

Now, let me turn to the issue of defense. Clearly, the reality of the world requires that there be a fairly husky level of military expenditures. Unfortunately, there is probably not another topic of anywhere near its importance that is so seriously constrained in public debate in these Halls. To question the military budget exposes one to serious doubts about his patriotism, particularly if one questions the expenditures very vigorously. Justified or not, defense expenditures are highly inflationary because they produce no consumable outputs. The profits and the wages generated in the production of war materiel and military preparedness will be spent, but they will not be spent on anything that was produced in that very process. They will be chasing after some other goods.

I'm not an expert in these matters, but my reading of the evidence is that 18-percent increment in military expenditures now being sought will not alter significantly the negotiating position of the United States vis-a-vis the Soviet Union. We are at a point where it is too costly for the Soviet Union to threaten us seriously. This is a time for less chauvinism and more statesmanship in the conduct of international relations. It is indeed this obsession with military power by hawkish policymakers around the globe which is leading us through a sequence of self-fulfilling prophesies.

If the administration has its way, the Russian hawks will demand that the Soviet Union respond with more military expenditures to nullify the change in their relative position. Our hawks will then respond by upping the stakes. Resources, at least in the short point, are finite. The cost of armaments must come from somewhere, and they generally come out of the hides of the poor everywhere.

Even if I were convinced of the additional defense dollars requested by the administration were necessary to preserve our defense posture, I would find it unconscionable that their cost should be born by the poor through reduced social programs in order to preserve the newly enacted tax breaks for the rich.

I think it is incumbent upon this administration, if it is convinced of the importance of these increases in military expenditures, to rethink its recent tax cuts. There are limits to the perceived injustice which the disadvantaged will continence before the social fabric tears.

We should not forget where we are and how we got here. The best evidence is that the Carter administration was rejected for its impotence in dealing with both domestic and international problems. The Reagan administration held out the promise of better times. It was given a chance and is still being given a chance.

But I dare say the mood of the cities could well turn ugly in the absence of some palpable evidence that the Government has not abandoned those least able to compete.

Let me turn to the issue of supply-side economics. Surely I find some merit in the ideas of the supply side, I think. When we think about them objectively, some of them are worthy of our acceptance.

Increases in productivity can come about in two basic ways: Increases in the quality of capital; or increases in the quality of labor. It is very clear that the administration's policies do not include increases in the quality of labor. Funds for training programs for working-age individuals, for nutrition programs for children, which would increase the quality of current and future labor, have been seriously cut.

On the other hand, the administration has instituted a number of inducements for individuals and businesses to save, the notion being that this saving will result in an increase of the Nation's capital stock. The administration has made available all-savers certificates, IRA's for everybody, and forgiveness of taxes on the first $750 of dividends on stock held in utility company reinvestment plans.

Will any of these make a measurable impact on savings? I think not. This is not to say that there will not be individuals who will avail themselves of these instruments or provisions of law. However, there is very little savings done in the household sector as a whole, and what is done is done by the very rich.

The illusion of saving in the household sector comes about largely because of price changes. Over two-thirds of the value of consumer assets can be accounted for by price changes.

What the administration believes to be inducements to save I believe are largely inducements to the rich to rearrange their existing portfolios to reduce their taxes. If they save some of the tax advantage, well enough, but it will be an insignificant contribution to the attainment of the administration's goals.

The administration has also provided inducements to the business community to save. These have taken the form of accelerated depreciation on assets and the creation of a market in tax deductions which permit corporations to sell their unusable deductions to other firms in a position to use them—to wit, the recent purchase of four deductions by IBM. This is tantamount to a negative income tax for corporations.

It does seem like the administration policies will induce some business savings. The question remains, however, as to whether or not these savings will be used for investment in improved capital.

Some undoubtedly will be used that way. Much of it, however, I fear will be used to buy up other firms.

It would be an extremely naive view that the motivating force of the marketplace is the production of goods and services. The motivating force in the marketplace is the production of money. If this can be achieved by producing goods and services, goods and services will be produced. If it is best done by mergers—which add nothing to output—that will be done.

The primary beneficiaries of the administration's tax policy to stimulate corporate savings will, in either case, be the shareholders of already successful firms. The only point at which firms will be enthusiastic about investing in real capital additions to their plant and equipment is when there is a manifested demand for the goods to be produced by new and existing capital. That demand will not come from the unemployed or those fearful that they will shortly be unemployed.

The great neoclassical economist Alfred Marshall, asked by a student whether supply or demand set prices in the market, responded with the analogy of the scissors, one blade representing supply and the other demand. Both blades are necessary, but one cannot say which blade does the cutting. If I have any advice for those policymakers who have embraced supply-side dogma, it is that they reconsider Marshall and become a bit more agnostic, and that they reconsider Keynes, who at one point said in the long run we will all be dead. They should reconsider Keynes and accept a planning horizon that has a little bit more of a mortal dimension.

PROPOSED POLICIES TO REDUCE INEQUALITY

Now, if I can take a couple of more minutes, let me make some comments about what we might do to lessen inequality or to at least prevent it from worsening. Of course, I'm not going to spell these out in any technical way, but I would like to make some broad suggestions and I will divide my suggestions into those which are essentially of a tax nature and those which are of a programmatic nature.

On the tax side, I would do away with the estate tax and replace it with progressive inheritance tax which had rates based upon the existing wealth of the inheritor plus the inherited amount. I would not, of course, tax the existing wealth of inheritors, but simply use it in determining rates to be applied to the inherited amount. The net effect of such a tax would be to tax the already wealthy considerably harder than the nonwealthy receiving the same size bequest.

I would revise the income tax so that unrealized capital gains and losses on financial assets were included in the tax base, along with realized gains. This would make unnecessary the preferential treatment of realized capital gains, which is intended to recognize that some gains accrue over long periods of time. The present approach is a miserable attempt at equity, that is the preferential tax rate, which ends up being more favorable to speculators than to anyone else. I'm not opposed to speculators. They perform a good function, but I would like them to pay their taxes.

I would also bring all interest into the tax base, including that on State and local bonds. I would eliminate the deduction of interest on consumer debt and limit the deductibility of business meals and lodgings to a fixed dollar maximum per person. I would set the maximum with an eye to covering only part of the well-heeled lobbyist's or businessman's expenditures in these areas and allow the rest to be borne by the customers of the company or the shareholders, depending upon the firm's ability to shift the incidence of the tax.

I would tax those inkind incomes which can practically be taxed. Free airline tickets to the employees of airlines, tuition breaks for the children of college professors are illustrative of what could practically be taxes.

On the program side, I would assure every child in America adequate nutrition and abundant medical care. I would make it possible for all people up to some age to borrow money from the Government to pay for training or a college education. I would treat these loans as liabilities to be paid out of future earnings and use the social security system to automatically handle repayment. I would provide for effective social insurance against those events over which one has little control, catastrophic illness, congenital defects, and the degenerative diseases of old age.

These efforts would produce a significant reduction in inequality, but the richest persons in society would still end up having several thousand times the wealth and the income of people at the bottom. My primary concern would be to raise the lower rank up closer to the mean.

[The prepared statement of Mr. Smith follows:]

PREPARED STATEMENT OF JAMES D. SMITH

Chairman Reuss, Members of the Committee and Guests:

I have been asked to address three broad areas related to the distribution of income and wealth:

1) Recent trends in the distributions and the causes thereof.
2) The impact of President Reagan's policies on the distributions.
3) What should be done to lessen inequality or prevent it from increasing.

Within these areas I will focus my comments largely on the distribution of wealth. I fear this is a case of the blind leading the blind. If I have any advantage over you in these matters it is only because I have been tapping my cane a bit more vigorously and have spent more time feeling along the walls which mark the outer perimeter of this darkness. There is very little data one can use to asses the distribution of wealth at a point in time or over time. Neither the administrative agencies of the Federal Government nor the research centers of the country have measured the ownership of wealth adequately for gauging public policy. The last serious effort by the Federal Government was in 1962 by the Board of Governors of the Federal Reserve System.[1]

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[1]Several years ago the Department of Health and Human Services initiated an effort to improve the measurement of income and to a lesser extent wealth distribution. A small but energetic group of government analysts were assembled to carry out the project known as SIPP, for Survey of Income and Program Participation. Unfortunately the program fell victim to this Administration's budget cutting policies. I can only conclude that the program was terminated by an over zealous, lower level bureaucrat rather than by Mr. Stockman's staff since the program was, among other things, designed to help measure the efficiency of a wide range of government transfer programs and also to measure waste which might occur where families and individuals were simultaneously receiving overlapping support from more than one program.

What Have Been the Recent Trends in the Distribution of Wealth?

Although it is well within society's technical ability to produce the answer to this question, the only truthful answer I, or anyone else, can give you at this time is that we do not know. In spite of the fact that every administration comes forth with economic policies whose efficacies are dependent upon the way that wealth and income are distributed, administrators have been too impatient to set in motion the basic research which would produce such fundamental knowledge. I say impatient because the first flow of information is likely to be three or four years after the research is started. Although such basic knowledge is one type of social capital required for informed public policy with respect to taxation, welfare and economic growth, it offers little glory to the initiators who will in all probability have left government before research bear fruit. I doubt the life expectancy of the average Assistant Secretary is as much as three years.

Although we lack comprehensive measurements of wealth ownership, one can piece together enough information to get a crude picture of what has been happening. Let me sketch that out for you.

Diligent and imaginative efforts of Jones and other scholars indicate the distribution of U.S. wealth in the Colonial and immediate Post-Revolutionary periods to be the most egalitarian in the nation's history.[2] With the exceptions of the periods around the Civil War and World War I, wealth inequality increased rather steadily until about

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[2]A. H. Jones, "Wealth Estimates for the Middle Colonies, 1774," Economic Development and Cultural Change, 18, no. 4, part 2, 1970; A. H. Jones, "Wealth Distribution in the American Middle Colonies in the Third Quarter of the Eighteenth Century," paper read to the Organization of American Historians, New Orleans, 1971; A. H. Jones, "Wealth Estimates for the New England Colonies about 1770," Journal of Economic

1929. The Great Depression brought with it a significant redistribution which continued to the end of World War II.[3] There then ensued a period of relatively stable economic stratification, terminated in 1969 by slight declines in inequality measured by Smith's estimates for that year.[4] Estimates by Smith for 1972 suggested the 1969 movement toward greater wealth equality may have been a statistical artifact.

However, preliminary estimates from work now underway at The University of Michigan suggest that the measured movement toward greater equality observed in 1969 may have portended a decline in the share of U.S. personal wealth held by the very richest one percent and one-half of one percent of the population.

All of the estimates of wealth concentration I have referred to for this century were made by applying to Federal Estate Tax returns a statistical technique which take account of the fact that the returns are in effect a sample drawn by death of the living population rich enough to pay estate taxes. Although the basic data provided by the estate tax returns are of very high quality, they permit one to observe

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History, Vol. 32, 1971, pp. 98-127; A. H. Jones, American Colonial Wealth: Documents and Methods, New York: Arno Press, 1977.

[3]For a detailed review of the studies of U. S. wealth distribution covering the period up to the Mid-Twentieth Century see Jeffrey G. Williamson and Peter H. Lindert, "Long-Term Trends in American Wealth Inequality" in James D. Smith (editor), Modeling the Distribution and Intergenerational Transmission of Wealth. University of Chicago Press, 1980.

[4]James D. Smith, "The Concentration of Personal Wealth, 1922 - 1969", The American Economic Review, LXIV, no. 2, 1974, pp. 162-7; and James D. Smith, "The Distribution of U.S. Wealth," U.S. Congress, House Committee on the Budget, Data on Distribution of Wealth in the United States, Hearings before the Task Force on Distributive Impacts of Budget and Economic Policies, 95th Congress, 1st Session, September 26 and 29, 1977, Washington: Government Printing Office, 1977, pp. 7-11 and 173-183.

only the extreme tail of the upper part of the distribution.[5] If the shape of the total distribution were constant, a time series of observations on any part of the distribution would tell us the level of the distribution. When the share of total wealth held by an observed part of the distribution changes, we know that the unobserved parts of the distribution must also change, but we cannot tell where in the unobserved part of the distribution the changes occur. One, therefore, must proceed with great caution when using data for a small part of the distribution to make statements about the entire distribution as we are doing here.

I stress the preliminary nature of our estimates because they are so striking and because they are the first results produced from Federal Estate Tax returns filed for estates of persons dying in 1976 and national balance sheet data from the integrated accounts work of Richard and Nancy Ruggles. If the estate tax files with which we are working do not contain significant errors, and our tests of the files have revealed none to date, and if the vagaries of statistical chance have not resulted in death drawing a grossly atypical sample, the estimates signal a remarkable decline in the wealth held by the crème de la crème of American wealth-holders. More particularly, the share of total personal wealth held by the richest one percent of wealth-holder declined from about 22 percent in 1972 to around 15 percent in 1976.

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[5]It is to the credit of the Statistics Division of the Internal Revenue Service that it has accepted a highly professional and scientific approach toward the production and analysis of data. The Division is itself in the process of making estimates of wealth-holding in 1976 by the population required to file estate tax returns. Those estimates will become available in the Fall as will estimates from The University of Michigan.

It is well for us to pause here to be sure we agree on what is being said. What has been measured in these recent estimates is the share of total wealth held by the very tip of the distribution. Where has the share of the wealth previously owned by the very rich gone? Has it been scattered broadly across the entire distribution? Our best guess is that it has merely shifted downward a few percentiles. This kind of redistribution from the super rich to the nearly super rich is redistribution to be sure, but it is hardly of social or economic significance. But again, this is our best guess of what has happened; not the result of analysis.

In order to provide you with some estimate of recent trends we used the recently available United States National Balance Sheets produced by Richard and Nancy Ruggles to recalculate past measures of concentration based on our personal wealth estimates for the United States from 1958 to 1976. We thus have a time series of wealth concentration from 1958 to 1976 consistent in both the national balance sheets and personal wealth estimation procedures.[4]

In Table 1 we present a new time series of wealth concentration estimates using the Ruggles Balance Sheets and new wealth estimates for the richest one-half of one percent and richest one percent of the U.S. population in 1972 and 1976. The personal wealth estimates for earlier years have been published previously and are reproduced here in

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[4]The new balance sheets produced by the Ruggles' were received with great enthusiasm. The author has for nearly a decade struggled with the problem of extracting from household sector balance sheets produced by Raymond Goldsmith and Helen Tice a "personal sector" which excluded the nonprofit and trust sectors. This was not done without considerable pestering of Goldsmith and Tice for special tabulation and for guidance. We are sure that at times our welcome wore thin and that they are as pleased as I am that the Ruggles have assumed the yeoman labors of carrying on and extending their past efforts.

conjunction with the new balance sheet numbers. The estimates of personal wealth for the rich were produced using consistent methods rather than "best methods" so that changes over time would be most visible. If one uses the best methods available for the improved estate tax data of the years from 1969 and later, the level of wealth-holding is found to be higher by about 15 percent for those years. Unfortunately the improved methods cannot be applied to the data for earlier years. It is also the case that one is limited to making estimates of the wealth-holding of not more than one percent of the U. S. population. This follows from the fact that the requirement to file a return in each of the years was $60,000 gross assets. Gross assets of $60,000 were considerably less likely to be owned in 1958 than they were in 1976, when no more than the combined value of a modest house and automobile could amount to that much.

Table 1

THE SHARES OF PERSONAL WEALTH OWNED BY THE RICHEST ONE-HALF PERCENT AND RICHEST ONE PERCENT OF THE U.S. POPULATION, 1958-1976

Asset	1958					1962				
	Value Held by Richest			Share Held By Richest[a]		Value Held by Richest			Share Held By Richest[a]	
	100.0%	0.5%	1.0%	0.5%	1.0%	100.0%	0.5%	1.0%	0.5%	1.0%
Real Estate[b]	$ 621.6	$ 62.5	$ 93.9	10.1	15.1	$ 767.7	$ 79.6	$117.8	10.4	15.3
Corporate Stock[c]	289.5	175.9	199.2	60.8	68.8	423.5	227.3	264.4	53.7	62.4
Bonds	83.6	31.3	36.0	37.4	43.0	96.0	33.2	38.4	34.6	40.0
Cash[d]	217.7	22.5	32.8	10.3	15.1	278.4	28.9	42.5	10.4	15.3
Debt Instruments	62.2	12.5	16.3	20.1	26.2	76.8	16.5	21.8	21.5	28.4
Life Insurance (CSV)[f]	65.8	7.5	11.3	11.4	17.2	78.9	7.1	10.7	9.0	13.6
Miscellaneous and Trusts[g]	338.8	45.6	52.8	13.5	15.6	380.9	NA	NA	-	-
Trusts	31.2	25.8	27.9	82.8	89.5	46.4	NA	NA	-	-
Miscellaneous	307.6	19.8	24.9	6.4	8.1	333.6	39.8	52.7	11.9	15.8
Total Assets	$1648.0	$332.0	$414.4	20.1	25.1	$2055.0	$432.4	$548.3	21.0	26.7
Liabilities[e]	$ 221.4	$ 29.2	$ 38.3	13.2	17.3	$ 307.5	$ 47.8	$ 61.0	15.5	19.8
Net Worth	$1426.6	$302.8	$376.1	21.2	26.4	$1747.5	$384.6	$487.3	22.0	27.9
Number of Persons (millions)		.87	1.74				.93	1.87		

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Table 1 (continued)

THE SHARES OF PERSONAL WEALTH OWNED BY THE RICHEST ONE-HALF PERCENT AND RICHEST ONE PERCENT OF THE U.S. POPULATION, 1958-1976

Asset	1965					1969				
	Value Held by Richest			Share Held By Richest[a]		Value Held by Richest			Share Held By Richest[a]	
	100.0%	0.5%	1.0%	0.5%	1.0%	100.0%	0.5%	1.0%	0.5%	1.0%
Real Estate[b]	$ 889.4	$ 94.4	$135.8	10.6	15.3	$1181.0	$117.0	$170.7	9.9	14.5
Corporate Stock[c]	541.2	317.2	364.9	58.6	67.4	732.4	366.3	423.3	50.0	57.8
Bonds	102.4	57.5	63.2	56.1	61.7	143.5	63.7	71.5	44.4	49.8
Cash[d]	368.3	43.7	62.7	11.9	17.0	496.3	48.1	71.2	9.7	14.3
Debt Instruments	88.4	19.8	25.4	22.4	28.7	113.8	21.9	29.6	19.3	26.0
Life Insurance (CSV)[f]	91.6	6.5	10.9	7.1	11.9	110.7	8.4	13.8	7.6	12.5
Miscellaneous and Trusts[g]	438.2	85.3	101.8	19.5	23.2	593.3	107.0	133.2	18.0	22.5
Trusts	59.8	49.0	52.7	81.9	88.1	73.6	60.0	64.5	81.5	87.7
Miscellaneous	378.4	36.3	49.1	9.6	13.0	519.7	47.0	68.7	9.0	13.2
Total Assets	$2459.7	$575.4	$712.7	23.4	29.0	$3297.4	$672.4	$848.8	20.4	25.7
Liabilities[e]	$ 407.7	$ 57.0	$ 73.1	14.0	17.9	$ 545.9	$ 75.8	$100.5	13.9	18.4
Net Worth	$2052.0	$518.4	$639.6	25.3	31.2	$2751.5	$596.7	$748.1	21.7	27.2
Number of Persons (millions)		.97	1.94				1.01	2.03		

Table 1 (continued)

THE SHARES OF PERSONAL WEALTH OWNED BY THE RICHEST ONE-HALF PERCENT AND RICHEST ONE PERCENT OF THE U.S. POPULATION, 1958-1976

Asset	1972					1976	
	Value Held by Richest			Share Held By Richest[a]		Share Held By Richest[a]	
	100.0%	0.5%	1.0%	0.5%	1.0%	0.5%	1.0%
Real Estate[b]	$1429.4	$150.9	$225.0	10.6	15.7	8.9	13.1
Corporate Stock[c]	785.2	429.3	491.7	54.7	62.6	36.9	44.2
Bonds	157.9	82.5	94.8	52.3	60.1	26.4	30.6
Cash[d]	671.7	63.6	101.2	9.5	15.1	6.7	11.1
Debt Instruments	127.6	30.3	40.8	23.7	32.0	18.7	24.6
Life Insurance (CSV)[f]	129.1	6.2	10.0	4.8	7.7	4.9	8.0
Miscellaneous and Trusts[g]	737.7	139.8	172.7	19.0	23.4	15.7	18.8
Trusts	93.1	80.3	89.4	86.3	96.1		
Miscellaneous	644.6	59.5	83.3	9.2	12.9		
Total Assets	$3945.6	822.4	1046.9	20.8	26.5	14.0	18.6
Liabilities[e]	$ 703.9	100.7	131.0	14.3	18.6	11.4	14.4
Net Worth	$3241.7	721.7	915.9	22.3	28.3	14.6	19.5
Number of Persons (millions)		1.04	2.09				

NOTES TO TABLE 1

a. Richness is measured in terms of gross assets. Net worth is preferred to gross assets as a classifier, but the microdata for 1958 which would have permitted such an arrangement have been destroyed by the IRS. The microdata for 1962, 1965 and 1969, and 1972 and 1976 were therefore ordered by gross assets to produce estimates consistent with those for 1958.

b. Real estate is shown at its market value without deduction of mortgages, liens or other encumbrances. In 1953 and 1958 only real estate located in the United States is included. In 1962 the value of real estate located outside the U.S. was brought into the estimate by a change in the law which made foreign real estate subject to estate taxes. The amount of such real estate is, however, seriously underrepresented because the law took effect late in 1962. Only estates for decedents who died after October 16, 1962 and who had acquired foreign real estate (except by gift or inheritance) after February 1962 were required to report it on estate tax returns. In 1965 and 1969 foreign real estate was included along with other real estate.

Included in real estate are land and structures for personal and business use. All other business assets are included in the "miscellaneous" category. Real estate held in trust is included here to the extent of the trust interest. A relatively small proportion of trust assets are in real estate, but the absolute value of all trust assets are understated here for reasons explained in the text.

c. Corporate stock includes all common and preferred issues. The value of shares in domestic or foreign firms whether traded or closely held. Also included are the value of certificates and shares of building and loan and savings and loan associations, Federal Land Bank stock and the value of other instruments representing an equity interest in an enterprise. Accrued dividends are also included. Stock held in trust is also included, but the absolute value is understated.

d. Cash includes balances in checking and savings accounts, currency on hand or in safety deposit boxes, cash balances with stock brokers and postal savings accounts. Cash in trust is included, but understated.

e. Liabilities includes all legal obligations except loans on life insurance policies.

f. Life insurance (cash surrender value) is the amount individuals could expect to receive were they to surrender their policies to the carriers. It takes account of policy loans, accrued dividends and unearned premiums.

g. "Miscellaneous and trusts" includes all assets owned in trusts <u>except real estate</u> and all assets other than real estate, corporate stock, bonds, cash, debt instruments, and life insurance (CSV) not held in trusts. Included are such items as consumer durables, personal effects, business assets (excluding real estate), mineral rights, tax sale certificates, judgments, lifetime transfers, and growing crops if not included in the value of real estate. This classification is shown here as an information item to explicate certain adjustments described in the text. It should not be summed with other assets to arrive at a total asset figure because trust assets are included within the individual asset types.

Miscellaneous assets are those described under miscellaneous and trusts less the trust assets. The miscellaneous asset category is added to other assets to arrive at total assets.

Trusts represent the actuarial value of reversionary and remainder interests in trusts. This actuarial value is substantially less than the total market value of assets held in trusts. On the basis of analysis reported in the text the national balance sheet totals (100 percent) have been adjusted to the reporting concept used for estate tax purposes.

The separate value of trusts could be estimated directly only for 1965. For other years indirect estimates were made by a method described in the text. The value for trusts is shown as an information item. The assets held in trust have been distributed to specific asset categories.

It is necessary to point out a few technical details underlying the table before proceeding. The asset and liability figures for "100 percent" of the population are the Ruggles Balance Sheet values, slightly modified to suit our needs. The original Ruggles numbers are end-of-year. Because our estimates from estate tax data are best thought of as mid-year estimates, we have taken the means of the pairs of the Ruggles end-of-year values which bound the individual years of our estimates. Secondly, the Ruggles Balance Sheets carry trust assets as an undifferentiated total. For our purposes we need to have the assets held by trusts distributed according to asset type because the Internal Revenue Service in coding Estate Tax returns distributes trusts asset without leaving a trail by which one can trace them. We distributed the Ruggles trust value by asset type according to information on the composition of trust available to us. We further modified the Ruggles trust figure to conceptually align them with the valuation of trust assets employed for U. S. Federal Estate Tax purposes. Whereas the Ruggles trust values are appropriately stated in terms of market value, the valuation of trusts for tax purposes is an actuarial one, taking into account the probability of realization and the present value of expected future realizations. The handling of trusts is explained further in the following section of the paper.

It is important to keep in mind that the data printed for the rich are for individuals, not families. Although the data from the 1976 tax returns could be used to represent eight to ten percent of the total U. S. population, the table is limited to only the richest one percent and the richest one-half of one percent, because the data for 1958 is capable of barely representing the richest one percent. It should also be noted that "richest" with respect to the table refers to <u>total assets</u>. One would prefer to use net worth as a measure of richness in these matters, but again the failure of the Internal Revenue Service to recognize the scientific merit of microdata in the period when the 1958 data were produced, and the agencies subsequent destruction of valuable machine readable media prevent our use of net assets as a classifier if the time series is to include the 1958 data point. [7]

The table suggests that there has been a great deal of stability in the concentration of net worth and gross assets over the years observed. For instance, gross assets owned by the top one percent of wealth-holders represented a quarter of the wealth of all persons in 1958 and remained within three percentage points of that value for all but one year between 1958 and 1972. In 1976, however, we see a significant decline to 19 percent. A similar pattern is found for net worth. Within the asset categories one of the more striking changes observed over the period is the decline of both the relative and absolute importance of corporate stock in the hands of the wealthy. This reflects the sluggish behavior of the stock market in the last six to seven years of the period.

In order to provide a longer perspective of the concentration of wealth in the United States, we have added Lampman's estimates from the period from 1922 to 1956 to our own and plotted them in the following chart. The collections of estimates are not completely comparable and because of the nature of the data from which the early estimates are

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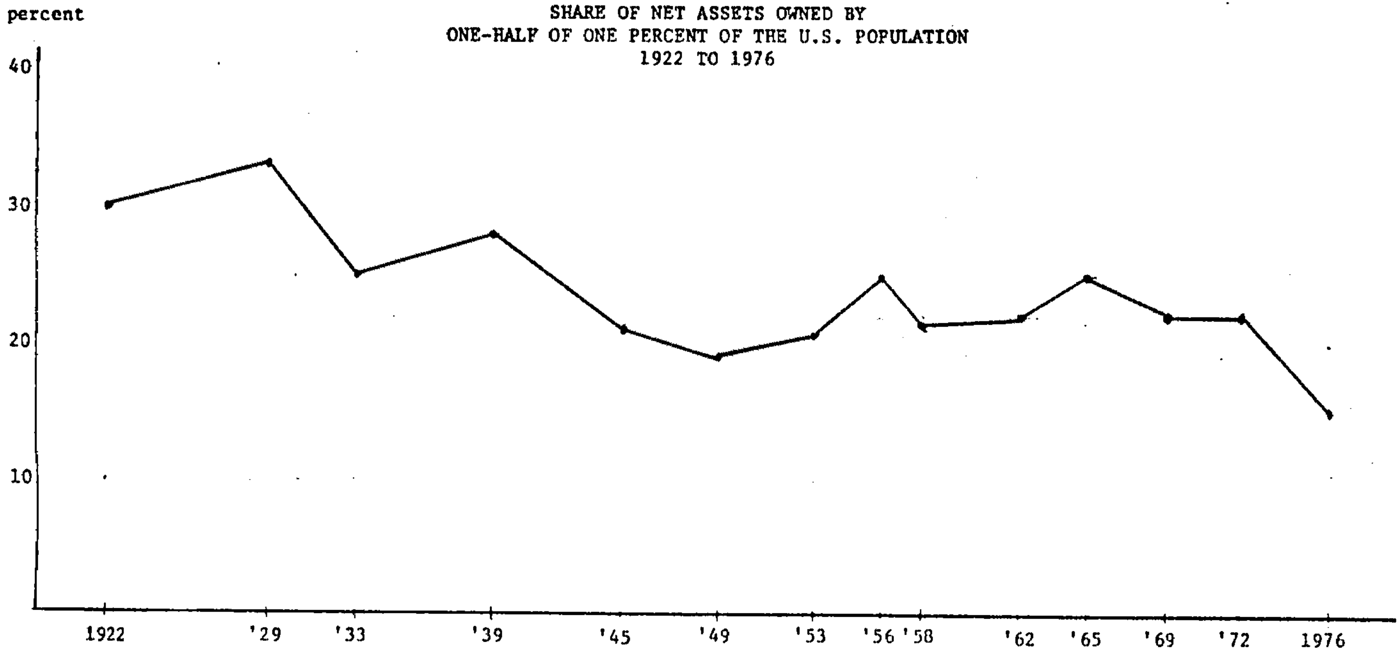
[7]It is of great pleasure to witness the aggressive movement of the Internal Revenues Service's Statistics Division toward a close relationship with the statistical community under its current director, who has himself been a serious student of wealth data.

SHARE OF NET ASSETS OWNED BY
ONE-HALF OF ONE PERCENT OF THE U.S. POPULATION
1922 TO 1976



derived, one has little ability to modify them to a common basis. Nevertheless, they are believed to be sufficiently similar so as to warrant some comparison. The chart clearly shows the egalitarian trend of the 1930s and 1940s and puts our own estimates in perspective. It is too early to tell if the 1969 and 1976 observations suggest that we are moving off the plateau of the two preceding decades and are in a period of redistribution or if the observations reflect sampling variability in the draw provided by death. With respect to the very steep decline in concentration represented by the movement from 1972 to 1976, we clearly need to fully assure ourselves of the quality of the data, a process which will be completed by year's end. It should be pointed out, however, that the decline in concentration observed from 1929 to 1933 was greater and the decline from 1939 to 1949 was nearly as great or that shown for 1972 to 1976.

<u>What Will be the Consequences of the Administration's Tax Policies on the Distribution of Wealth</u>

There is wide-spread agreement that the Administration's tax policies are intended to directly help the rich. It is hoped the benefits will trickle down to the poor in the form of higher levels of employment and presumably higher real wages. That outcome is not rushing upon us.

Turning to the specifics. We have never had an effective death tax in the United States. Since its inception in 1916 it has included ample provisions for the very rich to escape most of its apparent bite through the use of trusts and inter-vivos transfers. The Administration has for all practical purposes eliminated federal death taxes. I do not think that this was done in pursuance of a policy of economic growth, but in consequence of a philosophical view that one should be permitted to direct the disposition of his lifetime accumulation of wealth. At one time titles were also transferred at death and bequests could be made so as to disinherit a wife. There are few places where one can bequeath a title or disinherit a wife anymore; these prohibitions are founded on other philosophical principals. One can also argue that in a democratic society all persons should begin the race of life from as nearly the same starting point as practical and that the race should then go to the swift. At this point we are not debating appropriate philosophical underpinnings of a death tax but only asking how the Administration's tax policies will effect the distribution of wealth. The revisions in the Federal Estate Tax will lead to some increase in the concentration of wealth. The increase will not be greater because the old law was shot through with loop-holes.

With respect to changes in income taxes on individuals, the major changes have been to lessen the burden on the rich much more than on the non-rich. In the classified ads of small town papers one reads copy extolling even the petty rich to take advantage of the provisions of the new tax law and shelter income from the Feds. 'Buy a small apartment building and depreciate it over 15 years.' No matter what it will last a hundred. But for that matter, sell it after five years, take the capital gain at preferential rates, and let the new owner start the whole process again. Exclude the first $200 of dividends, the first $1,000 of interest from All Savers Certificates, buy municipal bonds and pay no taxes on the interest. Buy a tax deferred retirement annuity if you are a college professor. Then put an additional $2,000 in an IRA and exempt that from current income. Also defer payment on the tax on the interest generated by the $2,000 in the IRA. These provisions leave low-income, working people out in the economic cold and help people with income above the mean to increase their relative economic status. The tax law in existence prior to this Administration was preferential enough to the owners of property. The Administration's revision exacerbates an already bad tax code and serves as a force for increased inequality in the distribution of wealth.

What Will Be the Impact of the Administration's Overall Program

The avowed goals of the Administration were to improve the performance of the supply side of the market, reduce government waste and inefficiency, enhance the nation's military capability, free the market from government shackles, and move toward a balanced budget. The latter is apparently no longer a goal. It is very important to distinguish the Administration's goals from its strategy from attaining them.

I consider each of these to be goals worthy of society's efforts. Unfortunately, they tend to be long-run goals and the policies implemented to attain them are producing near-term havoc with little hope of achieving the desired ends. I do not by any means eschew short-run burdens for adequate long-term payoffs, but when the short-term costs become as high as they now appear to me, I cannot help but remember Keynes' admonition: "In the long run we will all be dead." Let me focus briefly on the Administration's policies for achieving each of the first four goals and and note their likely consequences for the distribution of wealth.

Supply-Side Performance

I would certainly agree that one ought to improve the performance of the supply side of the market. There is little question that the capital plant of the U.S. needs modernization in many area. And equally important the techniques of management which combine labor and capital can benefit from an examination of management techniques in other countries, perhaps most notably Japan.

Increases in productivity can come about in two basic ways: increasing the quality of capital or increasing the quality of labor. It is very clear that the Administration's policies do not include increasing the quality of labor. Funds for training programs for working-age individuals and for nutrition programs for children, which would increase the quality of current and future labor, have been cut rather than expanded. On the other hand, the Administration has instituted a number of inducements for individuals and business to save. The notion being that this saving will result in an increase in the nation's capital stock. The Administration has made available All Savers Certificates, IRAs for everybody and forgiveness of taxes on the first $750 of dividends on stock held in utility company reinvestment plans. Will any of these make a measurable impact on saving? I think not. This is not to way individuals will fail to avail themselves of these instruments or provisions of the law. However, there is very little saving done in the household sector as a whole and what is done is done by the very rich. The illusion of saving in the household sector comes about because of inflation. Over two-thirds of the value of consumer assets can be accounted for by price changes. What the Administration believes to be inducements to save, I believe are largely inducements to the rich to rearrange their existing portfolios to reduce their taxes. If they save some of the tax advantage, well enough, but it will be an insignificant contribution to the attainment of the Administration's purpose. The Administration has also provided inducements to the business community to save. These have taken the form of accelerated depreciation on assets and the creation of a market in tax deductions which permits corporations to sell their unusable deductions to other firms in a position to use them to reduce their taxes. This is tantamount to a negative income tax for corporations. It does seem likely that the Administrations's policies will induce some business saving. The question remains, however, as to whether or not these savings will be used for investment in improved capital. Some will undoubtedly be so used; much of it will, however, simply be used to buy other firms. It would be an extremely naive view that the motivating force of the marketplace is the production of goods and services; the motivating force of the markets is the production of money. If this can be best achieved by making goods, goods will be made; if it is best done by mergers which add nothing to output, that will be done. The primary beneficiaries of the Administration's policies to stimulate corporate saving will in either case be the shareholders of already successful firms. The only point at which firms will be enthusiastic about investing in real capital additions is when there is a manifested demand for the goods to be produced by new and existing capital. That demand will not come from the unemployed nor those fearful that they may shortly be unemployed.

The great neoclassical economist Alfred Marshall was once asked whether supply or demand determined market prices. He responded by the analogy of the scissors, one blade representing supply and the other demand. Both blades are necessary, but one cannot say which blade does the cutting. If I have any advise for those policy makers who have embraced supply-side dogma, it is that they reconsider Marshall and become a bit more agnostic and that they reconsider Keynes and accept a planning horizon of mortal dimensions.

Government Waste and Inefficiency

The efficiency with which government agencies carry out their mandates should be the subject of continuing scrutiny, administration after administration. Rapid social advances, such as occurred in the Sixties, can take place without mistakes. It is equally certain that agencies which operate without the benefit of full public scrutiny, such as Defense and the intelligence agencies, are very susceptible to poor management and waste. No less an authority on the matter of waste than Mr. Stockman assured us that there is a great deal of fat to be rendered in the Pentagon. We ought to trim fat, wherever it is found, but the butcher ought not be blind lest he take the marrow too, or emasculate himself.

Eliminating waste and inefficiency in government is the most popular topic of American political elocution. It is always a primary goal of the out-of-power party's candidates. It will soon become a Democratic Party Concern and will hold little appeal for the Republicans. I can only conclude that both parties are grossly inefficient at rooting waste and inefficiency out of government. In seriousness we should eliminate all the waste we detect, but one should not expect to make a big dent in the budget. Even if all the chauffeured government limousines in Washington were converted to ambulances, the subsidized lunches at the Pentagon were to be no more, all government dining rooms were stocked with Army surplus tin plates, all government travel was to be done at economy fares, and we reformed every last paper clip snitcher, the amount saved would be trivial in the face of the federal budget; its impact on the distribution of wealth nil.

Military Preparedness

Assuring that the United States has an adequate military force to dissuade foreign powers from abusing us is obviously necessary. The realities of the world are that there are policy makers in every land, including this one, who would exercise military power to gain their ends if the risk of retaliation and the political cost are low, even if the drain of the public treasury is high.

If ever there has been an area where enlightened public debate in these halls or elsewhere has been stifled by emotion and the threat of political ostracism it is the critical examination of defense spending. It is an area where administrations have mislead the public in the sincere belief that they were acting in the public good. And, as we have learned recently, members of the military have mislead the Chief Executive, and, I have no doubt, with the belief they were acting in the national interest.

Justified or not, defense expenditures are highly inflationary because they produce no consumable outputs which the profits and wages generated in their production can be used to purchase. It is difficult to determine how the direct expenditures for defense effect the wealth distribution. My guess is that it increases inequality slightly. The indirect costs, inflation and high returns on government debt, I think increase inequality significantly in the absence of controls, such as were imposed in Worlds War II.

I am not an expert in these matters, but my reading of the evidence is that the increase in military expenditures now being sought by the Administration will not alter in any significant way our negotiating position vis-a-vis the Soviet Union. We are at a point where it is far too costly to the Soviet Union to attack us. This is a time for less chauvinism and more statesmenship in the conduct of international relations. It is indeed an obsession with military power by hawkish policy makers around the globe which is leading us through a sequence of self-fulfilling prophecies. If the Administration has its way and increases outlays for armaments, Russian hawks will demand that the Soviet Union respond by more military expenditures to nullify the change in their relative position. Our hawks will then respond by upping the stakes. Resources are, at least at a point in time, finite. The cost of armaments must come from somewhere and they generally come out of the hides of the poor everywhere. Even if I were convinced that the additional defense dollars requested by the Administration were necessary to our defense posture, I would find it unconscionable that the cost should be born by the poor through reduced social programs in order to preserve newly-enacted tax breaks for the rich.

There are limits to the perceived injustice the disadvantaged will continence before the social fabric tears. We should not forget where we are and how we got here. The best evidence is that the Carter Administration was rejected for its impotence in dealing with both domestic and international problems. The Reagan Administration held out promises of better times. It was given a chance and is still being given a chance, but I dare say the mood of the cities could well turn ugly in the absence of some palpable evidence that government has not abandoned those least able to compete.

What Should Be Done to Lessen Inequality or Prevent It From Worsening

I will divide my suggestions into tax and programmatic areas. On the tax side I would do away with the estate tax and replace it with a progressive inheritance tax which had rates based upon the existing wealth of the inheritor plus the inherited amount. I would not, of course, tax the extant wealth of inheritors, but simply use it in determining rates to be applied to the inherited amount. The net effect of such a tax would be to tax the already wealth considerably harder than the non-wealth receiving the same size bequest.

I would revise the income tax so that unrealized capital gains and losses on financial assets were included in the tax base along with realized gains. This would make unnecessary the preferential treatment of realized capital gains which is intended to recognize that some gains accrue over long periods of time. The present approach is a miserable attempt at equity which ends up being most favorable to speculators than anyone else. I am not opposed to speculators, they serve a good purpose, I just want them to pay the taxes like the rest of us. I would also bring all interest into the tax base including that on state and local bonds. I would eliminate the deduction of interest on consumer debt, and limit the deductibility of business meals and lodging to a fixed dollar maximum per person. I would set the maximum with an eye to covering only part of what a well-heeled lobbyist or businessman might expect to shell out for lunch or dinner, and allow the rest to be borne by the customers or shareholders depending upon the ability of the firm to shift the incidence of the tax. I would tax those in-kind incomes which are practical to tax--free airline tickets for the employees of airlines and tuition breaks for the children of college professors are illustrative of what could practically be taxed.

On the programmatic side I would assure every child in America of adequate nutrition and abundant medical care. I would make it possible for all people up to some age to borrow money from the government to pay for training or a college education. I would treat these loans as liabilities to be paid on future earnings and use the Social Security System to automatically handle repayment. I would provide for effective social insurance against those events over which one has little control: catastrophic illness, congenital defects, and the degenerative diseases of old age.

These efforts would produce a reduction in inequality but the richest persons in society would still have several thousand times the income and wealth of the poorest.

DISCUSSION OF WHO WILL BE HURT BY REAGAN PROGRAM

Representative REUSS. Thank you, Mr. Smith, and thanks to all the panel for a very instructive morning. It seems to me, Mr. Budd, Mr. Danziger, Mr. Rousseas, and Mr. Smith, I except Mr. Shilling who has a different view, but I think the four mentioned would, in general, agree with the proposition I'm about to state, which is that the ideal of equality of Thomas Jefferson will, under the Reagan program, if carried out, be very substantially worsened, and that there will be large shifts in the shares of income, the shares of wealth away from not just the poor but the lower 70 or 80 percent of American families and individuals to the top 5 to 10 percent.

Mr. Rousseas, would you agree with that?

Mr. ROUSSEAS. Yes, I would.

Representative REUSS. Mr. Danziger.

Mr. DANZIGER. Yes.

Representative REUSS. Mr. Smith.

Mr. SMITH. Yes, in terms of the shares, yes.

Representative REUSS. And Mr. Budd.

Mr. BUDD. Yes, I would. I'm not sure about the size of the shift at this point.

Representative REUSS. Mr. Budd, you made an interesting point. While everybody knows that the current economics is going to hurt the poor and blacks and Hispanics and the elderly poor, the working poor, and many other groups, you made the point, I believe, that it is also going to hurt the young, those under 35 to 40.

Mr. BUDD. Yes, I made a definite point, particularly on the assistance to students that the Reagan administration is going to cut very substantially.

Representative REUSS. The reasons for this, and I think you are right—the reasons I think you are right are quite simple. The change in expenditure policy and tax policy and monetary policy in the last year has been to enormously increase the share that goes to property. If you've got it, you get it.

Mr. BUDD. Right.

Representative REUSS. If you had it last month, you got a perfectly splendid tax decrease of almost a third, from 70 percent to 50 percent, and you could then use that marvelous accretion to your wealth by buying Treasury bills this week for more than 14 percent for a 3-month obligation, not just guaranteed by the Federal Government, but issued by the Federal Government itself. Since people under 35 tend not to have very much wealth, they obviously are going to get the short end of the stick on this new dispensation, are they not?

Mr. BUDD. Right. Most of the shared property income does go to the middle and older age groups.

Representative REUSS. Is it not also a fact that young people, people under 40, I guess we can say, have the same desire as anybody else to own a home. But isn't it a fact that with the huge speculative buildup of the prices of homes, old and new, and with the drastic 16-, 17-percent mortgage rates that people have to pay, that young people are cut off from what has been in our lifetime an American dream, the right to own a home of your own; is that right?

Mr. BUDD. Correct.

Representative REUSS. And isn't it further a fact that since young people tend to have less property because they haven't been around long, increasing payroll taxes and inflationary bracket creep make any income tax cut they get of jellybean proportions. So in the race of life, they are going to be worse off. Isn't that your point?

Mr. BUDD. I did want to say, however, that I presented no figures on inequality within the older age groups, and it's certainly a mistake to suppose that property income or high income is evenly spread among those groups, particularly age 65 and over, where we know that inequality within that group is much greater than it is for the remainder of the distribution.

EFFECT OF REAGAN BUDGET CUTS ON ECONOMIC DATA

Representative REUSS. I congratulate you all for a valiant attempt to make sense out of a field where there is a singular dearth of good statistical material. I was dismayed the other day when Commissioner Janet Norwood from the Bureau of Labor Statistics told us that due to administration executive fiat, they are cutting down markedly on the amount and accuracy of our unemployment figures. And I am distressed today to be told by our witnesses, mainly Mr. Budd and Mr. Smith, that the excellent survey of income series which the Federal Government has kept for some years has now been totally disbanded.

This tendency on the part of the administration to tear up the unemployment statistics and to tear up the statistics relative to the distribution of income and wealth would lead a legislator of suspicious mind to suspect that this was a giant coverup. Such a statistical attempt to fudge the unemployment figures and the income and wealth figures would be a heist on the American people of cosmic proportions which dwarfs any penny ante coverup that Richard Nixon might have done. Would you comment on that?

CUT IN EDUCATION FUNDS WILL HURT PRODUCTIVITY

Mr. ROUSSEAS. Could I add something that troubles me very much as both an economist and educator? The economists, for a long time, have been talking about the importance of investment in human capital. Here we have an administration that's concerned with increasing productivity, as we all are. It's a legitimate concern. But clearly, if you're going to cut down the investment in human capital, this is going to turn out to be counterproductive.

We've just heard, for an example, at our major prestigious universities like Harvard, Princeton, Yale, they are going to increase their tuition to $11,000-$12,000, by 15 percent. More significantly, Wesleyan University is going to stop the blind admission program. Others will be forced to this. One of the reasons, obviously, is the cutbacks in grants for education. So our most prestigious universities, now, will be forced to take really the children of the upper income classes and the very wealthy. At the same time, our State governments are going to be strapped for funds. They're going to have to increase taxes or cut expenditures, and the great State universities that we built up in this country, apart from our prestigious private universities, are also going to be cut back.

Student loans are being cut back. This also is an aspect of distribution from the point of view of investment in human capital, and as a professor in a college which is now coed, we have been very much concerned, since our financial aid budget is about $3 million a year. The question is are we going to be able to continue this, or is the fact that you're going to be reduced simply the extension of the domestic staff of the very wealthy?

You will also kill these institutions, as well as the lower income groups not even having access to higher education. From the point of view of investment in human capital, this works against the very productivity concerns of the administration.

Mr. SMITH. And exacerbates it.

Mr. ROUSSEAS. Absolutely.

Mr. DANZIGER. Could I add a point?

Representative REUSS. Mr. Danziger.

Mr. DANZIGER. There is another human capital effect that is probably less obvious and relates back to the poverty population that I talked about. One of the changes in AFDC that went into effect in October was that you no longer qualify for AFDC until the sixth month of pregnancy, and in most States that means you also don't qualify for benefits from the women and infant children for medical benefits. Previously you could qualify for AFDC benefits at the third month of pregnancy, once it had been vertified by a doctor. So in terms of human capital, it looks in the short run that we're saving some money, but physicians and other researchers have shown that this second trimester of pregnancy is a very important one for fetal development, so what we are likely to have is a reduction in medical care and food aid and cash assistance to women during pregnancy, and this is likely to lead to an increase in low birth weight babies, which would be very expensive medically once they were born, or an increase in infant/maternal fatality. That's another human fatality aspect which I don't think is very obvious, but one of the budget cuts.

Representative REUSS. Many of the witnesses have pointed out the very rough effect on the poor of these budget cuts, just as Mr. Danziger has now explained. Is it not a fact, however, that that group in our country which refers to itself as the great middle class, I suppose that's the second, third, and fourth quintile of income receivers, maybe a little bit of the top quintile, are going to suffer under some of these budget cuts by losing clean air, clean water, university loans and aids, help to the arts and humanities; isn't that so, Mr. Rousseas?

Mr. ROUSSEAS. Certainly.

Representative REUSS. Now, Mr. Shilling—well, first you come back at me, then I wanted to ask you a question.

RESPONSE TO SPENDING CUT CONCERNS * * *

Mr. SHILLING. I have been sitting here, obviously, listening. I think you, as chairman, and the other panelists here express a great deal of concern about cutbacks. Of course, I can understand that university professors are particularly keen on seeing cutbacks in aid to education one way or the other. I would feel the same way if it were aid to business consultants that were suddenly cut back. So gentlemen, I can understand your concern.

Mr. BUDD. We're worried about the students.

Mr. ROUSSEAS. There is a qualitative difference.

Mr. SHILLING. May I continue without your interruption, if you don't mind?

I can certainly understand the concern about cutbacks in many programs that are designed to help people who have problems one way or the other, whether it's low-income people, people who need medical care, deserving students and so on. But I think that all of this sounds to me very, very much like a statement of something that every economist, I think, learns just isn't so, and that is that there is free lunch. The point is that these programs obviously have a cost.

* * * EXCESS SPENDING CREATES INFLATION

It seems to me one of the things we've proved conclusively over the last several decades is that the cookie jar is now empty. Our work indicates very clearly that the highest correlation with inflation in the long run is the percentage of the economic pie controlled by the Government. What that, in effect, means is that there is excess spending in the economy relative to the economy's ability to produce those goods and services and inflation is simply the mechanism by which that is shifted in favor of the Government as a spender.

In other words, if you don't have the resources, then, all you are really doing is simply changing deck chairs on the *Titanic*. To suggest that you shouldn't cut back this or that is all well and good. If you don't have the resources to do it, then obviously there is no net gain.

Just a word on what inflation does to lower income people. I think that there should be benefits of greater and greater magnitude for lower income people or disadvantaged people. I think that's a perfectly altruistic feeling. But the point is, if the costs are straining our resources and are an inflationary problem, it seems to me axiomatic that those are the people who are the big losers. To say they have a net gain out of this when the economy ends up being very distorted and very unproductive, I think is simply not true.

Representative REUSS. May I say, Mr. Shilling, that you play a valuable role at this hearing.

Mr. SHILLING. Thank you.

Representative REUSS. And you were invited because of those inherent values and I'm delighted to hear you speak up.

Would you not agree on the subject of free lunch—and let me say I love free lunches, always have—doesn't the person of wealth who invests in an all-savers certificate, or the corporations which engage in the exchange of depreciation and investment tax credits, or the homeowner who gets a huge subsidy not just on his principal home but on his ski lodge in Aspen and his home in Hope Sound, don't these goodies partake of the free lunch, too?

Mr. SHILLING. I wouldn't for a moment suggest that there aren't inequalities and ridiculous extremes that are generated on either side. It seems to me, though, that the key point is that we have had, really, for 50 years, a program which has become excessive, at least the last couple of decades on one side—and I'm not suggesting everything you do to move it to the other side is going to be without its problems and its ridiculous extremes. But it seems to me we've gone so far on one side that it doesn't hurt to at least try to even out the balance in the name of trying to create an economy which does have a much lower inflation rate and much more of a productive bias, as oppoosed to a bottomless cookie jar, free lunch bias.

Representative REUSS. Before recognizing Mr. Richmond, I have intruded on his time, let me just say I would have thought a good way to swing that pendulum would have been to swing it toward the middle, eliminate free lunches for welfare moochers and others, wherever found, but don't create new classes of moochers at the upper end of the income scale. And I'm glad you agree with that general proposition.

I have another question to ask you, but we will wait. Mr. Richmond.

Representative RICHMOND. Thank you, Mr. Chairman. First of all, I would like to congratulate you on the singular panel you have up here. I think we have a very broad spectrum of opinion in these panelists.

Gentlemen, can we all agree on one thing: that on our present course we are bound for a deficit, which will be between $100 and $150 billion for this year alone, with unemployment of around 9 percent—not including the other 1 or 2 million people who are not listed in our unemployment figures because, like many young people in my own congressional district, they are high school dropouts, they never applied for a job, therefore, they don't exist on any unemployment figures. We've got tens of thousands of these individuals, both male and female, who through lack of parental guidance, through lack of any type of homelife, any inspiration toward education, drop out of high school in their second or third years, the girls very frequently get pregnant so they can establish their own household, and the boys very frequently get in trouble with the law. Now, those people aren't on our unemployment list at all, as you know.

So here we have our gigantic deficit; we have unemployment of between 9 and 10 percent, if you want to take real unemployment; we know for a fact that every percent of unemployment costs the Federal Government roughly $25 billion. Probably unemployment is among the most wasteful things we can have in the United States, because not only do unemployed people not pay taxes, but they take $25 billion per million.

And we have inflation, which is hardly down to reasonable numbers. I think inflation this year can go anywhere from 7 to 9 percent. And then we have, last thing, interest rates which, given the items I have mentioned before, can't possibly go below 15 percent. In my opinion, they're going to go higher.

Now, once you have interest rates at that level it means people can't buy houses; they can't buy automobiles. It seems to me that we are headed for a deep, deep recession and that Reaganomics offers no hope whatsoever for the next couple of years—and there will be no hope until this Congress and the administration change the course we're on now.

Is there any economist here that disagrees with any statement I have made? If so, I'd sure like to hear it.

Mr. Shilling.

Mr. SHILLING. Yes, sir, I would agree that the risks in the economy are definitely on the downside. We've been on record for some time suggesting that we could have a very long drawnout recession with major risks to various financial institutions and aspects of the economy.

Representative RICHMOND. You have some of the major corporations in the United States going into bankruptcy now: General Motors, Ford, Chrysler, International Harvester. The greatest agricultural equipment company in the world, John Deere, had every single one of its factories closed in January. What does that tell you?

Mr. SHILLING. I think not only are they on the verge of bankruptcy, I think some of them are basically dead but are too big to get into the coffin and get the lid closed. But I would suggest that the cause of this is probably not so much the current actions that have been taken here in Washington, many of them with congressional involvement, I might add, but I think it has been a long history of inflation, which since 1975 has convinced this country that inflation was here to stay.

Representative RICHMOND. Mr. Shilling, your $100 to $150 billion deficit in itself has got to force interest rates up, which would increase during inflation.

Mr. SHILLING. I think that's correct.

POLICY RECOMMENDATIONS BY REPRESENTATIVE RICHMOND

Representative RICHMOND. If that's correct, what are we doing? My answer, of course, is why don't we look at history and look at the things President Roosevelt did to get this country back on the track again, like an RFC, like a CCC, like all of those letter agencies that the President installed which somehow or another got us through some very troubled times, like a WPA—people to this day are using WPA bridges and WPA forms of recreation throughout the United States. If it weren't for the WPA, we wouldn't have the bridges we have in the United States today.

Now, isn't it about time we started repairing those bridges? Isn't it about time we increased our highway use tax by 10 cents a gallon, so we can use these tax moneys and put people back to work? Shouldn't we start realizing the administration policy is a failure, a disaster? Isn't it about time for the administration to go to this Congress, in order to save the United States, with changes in some of these policies and shouldn't they change them very quickly? Like, for example, consumer interest. As the chairman said, why should someone who just spent a million dollars for a home in Hope Sound and got himself an $800,000 mortgage, why should that interest rate be deductible? I don't mind having his primary home deductible, but why should anyone be able to deduct his private car. his private yacht, and several houses?

I just came back from Vail, Col., this Christmas. You know what a lot is selling for in Vail, Colo.? Just an empty lot. A million dollars. That happened to be, of course, next to Gerald Ford's house. The house on the lot originally cost $40,000. Some damn fool in Colorado paid a million dollars for that property and of course he financed the whole thing. And who's paying for it? We are.

Now, do you think that sort of system ought to continue? Don't you think we ought to repeal the tax deductibility of luxury goods, like second and third houses, fur coats, jewelry, and all the other things that the people charge on their credit cards?

Mr. SHILLING. Maybe we should.

Representative RICHMOND. Don't you think we are coming to a point now where we must do something?

Mr. SHILLING. I wish at the same time, Congressman, we could wave a wand and do away with all the inflation in tangible assets and the heavy borrowing that people have done during the period they assumed inflation would last forever and they could always pay back in cheaper dollars, and they would never see the end of——

Representative RICHMOND. Mr. Shilling, American industry isn't buying—the machine tool industry, much to my amazement, after these great Reaganomic tax cuts and whatnot, instead of going up is going down. Last year we lost 30 percent of our business. In the month of December alone, machine tool orders dropped 50 percent. That tells you one thing; it tells you American manufacturers aren't making use of Reaganomics in their tax benefits to reinvest money in their factories. Now if this Nation doesn't modernize its factories, we are dead. A country half the size of ours in population, physically the size of the State of Montana, will has a greater industrial output next year than we have: Japan. Why? Because of their new equipment and modern factories and a sensible tax code.

Don't you think you folks ought to start realizing we are in severe, deep, deep trouble and not just take the President's plan at face value? He is going to get us into a worse depression than President Hoover ever, ever thought of getting us into.

Am I saying anything anyone disagrees with? Mr. Smith.

Mr. SMITH. I don't know that I disagree with anything that you have said, but I have to take this opportunity to agree with Mr. Schilling. I don't think that this situation is the making of the administration.

Representative RICHMOND. Agreed.

Mr. SMITH. It's been a long time in the making.

Representative RICHMOND. I'm sure the chairman will agree too.

INCOMES POLICY

Mr. SMITH. In large part it's a failure to recognize the structure of the American economy is not a simplistic notion of introductory economic textbooks.

Unfortunately, I think the corrective measures that the administration is trying to take assumes it is and that somehow or another we are going to go back to some period when you could use the Fed and use a simple amount of fiscal policy and that would take care of everything, and then the great invisible hand would work. That doesn't exist. That's an illusion, and unless we are seriously prepared to talk about incomes policies, other methods, unless we are willing to break with the old ways of thinking to explore new ways, we are not going to act concering this problem that I think the administration is not responsible for, but the administration is going to exacerbate it enormously, and it's going to speed up, I suspect really, the serious consideration of incomes policy.

It does seem to me that we are being pushed onto a track that is going to, at the very best, cause a rethinking of how we handle the economy, how we manage it. At worst, it's going to cause a social disaster, of cities blowing up again.

RELATION BETWEEN DEFICITS AND INTEREST RATES

Mr. ROUSSEAS. A lot of mention has been made about interest rates and the deficit, and I'd like to make a brief comment on this. This concerns me very much. I do believe that the deficits—the present administration puts it about $92 billion, the CPT about $150 billion—is going to have an effect on the interest rates. What's not discussed is why is it going to have an effect on the interest rates.

The argument here over and over again is a crowding-out hypothesis. This is where we have to zero in. What is that? If the Government is to come in to finance that debt on the finacial markets and credit markets, it's going to push out the private sector of the economy, and therefore stop the recovery, and really cause inflation, and interest rates to go up behind that. Is the monetary policy worth following? Because from October 1979 Mr. Volcker, when the target monetary policy was shifted from interest to some notion of a monetary aggregate or monetary base, again on the basis of the theory which I think has no basis in fact; namely, some version of the quantum theory of money. That is, the crowding out effect exists and has this negative effect because of a belief we have in a theory of inflation based on money supply. That is a tragedy.

We always hear about a monetization of the public debt. Well, quite frankly, I am going to be very heretical and say, well, to a degree we must monetize part of that debt, and we must get interest rates down by getting interest rates our target, and that's simply some form of a monetary base.

Also, Mr. Shilling has spoken quite persuasively about the notion of savings in this economy, what's happened to the savings ratio. Well, I'm benighted enough to think that one of the best ways of getting savings up is to move the economy to full employment. Nobody even mentions this. We have tax policies. The tax policies of this administration are going to cause a deterioration in the distribution of income.

Professor Smith has rightfully said that we don't have any data; we don't know really what the distribution of wealth is. Well, my answer to that is whatever the distribution of wealth is, I argue it's going to get worse. Since that is a stock, the flow of income is going to get worse.

REAGAN POLITICING INCOME DISTRIBUTION WITH DIRE CONSEQUENCES

And I would like to end by referring to Max Veblen, who many years ago evolved a theory of legitimation. No society will continue and survive unless it is seen as just by the mass of the people. The minute a society is delegitimated it becomes destabilized. When our problem is growth, as long as you have growth and there's no problem with distribution of income, it is depoliticized. What this administration is doing is repoliticizing the distribution of income in a situation of no growth and in the situation where its policies are not going to contribute to the stimulation of growth, but have the exact opposite effect; that is, to put it bluntly, I think we are going to blow ourselves up.

Representative RICHMOND. So do I. Thank you, Mr. Chairman.

Representative REUSS. Thank you.

Mr. Shilling, I said I had a question for you. Looking at your prepared statement, I notice a number of truths that are self-evident. You say, "Upper income people are the big savers and lower income people the big spenders." No doubt about that.

You say, and again you are right as can be, that "the policies we are now embarked on are going to keep interest rates at high levels."

Then I want to refer to where you give your optimistic prediction. You say that "the years ahead as consumers finance the likely catchup surge in auto sales and the appliance and household furnishings boom, that would accompany the residential construction explosion," you point out that that group will have to dissave, they will have to spend more than they are making, poor souls, to do that. But the pot of gold at the end of the rainbow is the rich people who, under this program of Mr. Reagan's, will have more, and since they are the big savers they will lend to the average person so that this great boom will continue.

Isn't that what you are saying?

Mr. SHILLING. No, I'm not, Congresman.

Representative REUSS. Might be nothing wrong with saying that?

Mr. SHILLING. Frankly, I don't think that any of us really know enough about what increased inducements to save are going to do in terms of who is going to do the saving. Now, there's no question that cutting income taxes the way the bill enacted last summer cuts them does do a lot more to induce saving among upper income people, because it's a proportional cut and they end up with a much greater increase in their aftertax income, as I've shown in table 6. Consequently, since they tend to be big savers, and if we're talking about the superrich, the consumption probably changes very little with an increase or decrease in income. So it's really a question of coming in or out of savings.

I think that's true, but I think some of the other things that are occurring may increase saving right now, I frankly think that we in our firm know very little about it. I'm not sure anybody else does either. Let me give you an example.

Right now, for the first time in decades, because of the limit, the decline in taxes to 50 percent on all income, plus the historically wide spread between inflation rates and interest rates, it is possible for the first time in decades for virtually everyone to have an after-tax real rate return on savings as invested in a fixed-income security.

Now, who is going to be induced to save more to take advantage of that? Frankly, I don't know. I think to say simply the superrich, whose consumption is probably pretty much fixed anyway, just doesn't make sense. I think, obviously, if that's the type of thing that's going to be effective, it's going to hit a lot of us who are below that category, obviously above the very bottom rungs, where people dissave at a very great rate, as I pointed out.

But to say this is somehow all going to flow to the superrich and them simply lend to the vast middle class, I don't think we know enough to say so. I would suspect that if that were the only impact, then these programs obviously wouldn't generate much more saving at all.

DISCUSSION OF REAGAN PROGRAM ON SAVING AND BORROWING

Representative REUSS. I guess we must read together right now the paragraph starting with the words "The saving rate." You say, "The saving rate is also likely to be depressed by the tremendous borrowing we expect in the years ahead as consumers finance the likely catchup surge in auto sales," and then I read the rest of it. Then having made that statement, you said, "Ah, but all is not lost because as a result of the Reagan economic policy changes, those at the top will save more, so that will compensate for the greater borrowing by the lower 70 percent, whatever it is."

Mr. SHILLING. Congressman, do I say the saving is going to be entirely done by those at the top? If I did, I miswrote.

Representative REUSS. You say, "The saving is going to be depressed by the tremendous borrowing we expect in the years ahead as consumers. * * *" I'm afraid you are right. Far from accusing you of misrepresenting matters, I accuse you of being an honest historian.

Mr. SHILLING. Not really, Congressman, with all due respect, the way I am discussing this, going back to the previous pages, I am first talking about the inducements to saving, not only the tax cut effects but also the IRA's and so on and so forth. And I'm saying these things tend to increase the saving rate, but when we get them all through, lo and behold, we only end up with what, by historical standards, is no great shakes in terms of saving rate.

Then I go on to say, "The reason it doesn't give us a bigger increase than that is because there are offsets." Now, those stimuli and offsets could indeed occur in precisely the same person. Someone who was in the mood or in the stage of life to say, buy a new car, who is driving around a junker now, and economic conditions improve and his income increases and he wants to buy a new car, indeed, he could dissave in the process of buying that car, but at the same time he could be induced to save more than he otherwise would have.

So, in other words, you can have forces working both ways, indeed, within the same individual.

Representative REUSS. Your vision of the American consumer is that of a dumkopf of monumental proportions. He's supposed to be saving tremendously and develop a nice little nestegg, and then borrowing tremendously to buy those dandy autos and household furnishings and homes that you are talking about. That poor fellow who constitutes 80 percent of the population is going to be in terrible shape if that's his household management policy.

Well, I did want to raise it because I happen to believe in the postmortem on the Great Depression of 50 years ago, delivered by the eminent banker, Frank Vanderlip, who after the event said, "Yes, the Depression was caused by the fact that workers and farmers didn't have enough and those at the top had too much, so there wasn't enough purchasing power to take off the market that which the economy was then capable of producing." It's because of my urgent desire that we not repeat the Great Depression that I pursue you with these little catechisms. But I'm very grateful to you, as always, and to the panel as a whole I would say, "Where have you been all my life?" You've been a breath of fresh air today. Working with miserable statistical basis, you have been able to focus a great deal of commonsense on our present miseries.

As I mentioned earlier, Prof. William Ryan of Boston College was unable to be with us today. I will include his statement in the printed record.

[The statement referred to follows:]

STATEMENT OF WILLIAM RYAN, PROFESSOR OF PSYCHOLOGY, BOSTON COLLEGE

The present crisis in America is a crisis of inequality. The economic gap between the rich and the rest of the nation, which has been growing all during the 1970's, has been widening more and more rapidly. It has been said that the policies of the present administration have resulted in the rich growing richer and the poor growing poorer. It would be more accurate, I think, to say that the rich are getting richer while the rest of us—the great vulnerable majority of Americans, consisting of people who work for a living—are all getting poorer. Not only poorer in our weekly or monthly paychecks, but poorer with respect to what we own, poorer in our sense of security against misfortune and disaster, in the risk of death, injury, and illness to which we are being exposed, and, most important, poorer in the state of our moral and spiritual well-being. This inequality crisis is more fundamental than—or perhaps it is a summation of—the unemployment crisis, the inflation crisis, the productivity crisis, the interest rate crisis and the tax crisis.

The crisis is particularly unsettling and, I believe, particularly dangerous because it reverses a long-standing trend toward greater equality. From the end of the 1920's to the end of the 1960's, American society had been growing more equal with respect to the distribution of its abundance. This overall advance toward greater equality, which had been spasmodic and marked by irregular movements forward and backward, was sharply reversed as we moved into the 1970's and the gains of previous decades are being rapidly eroded. As a simple index of the process we can look at the relative shares of income received by the top 20 percent of the population—those who are the most affluent—and that received by the lower 60 percent—what might be termed the average working man and woman. In 1929, the more affluent 20 percent were receiving more than half of all personal income, while the lower sixty percent was receiving only about one-quarter. By the end of the 1960's, the share of the well-to-do had fallen to 41 percent, that of average families had risen to 36 percent. This was a significant change—not as great as many of us might have hoped for, but it meant a significant change in the standard of living, the well-being and the economic security of the majority of Americans. For example, this change represented the equivalent of about 2500 1969 dollars per family among those in the bottom sixty percent. This may not seem like much when you have it; it's a small fortune when you don't.

Now we are moving in the opposite direction. By 1978, the well-to-do were back up to 45 percent of income, the average family back down to 30 percent. There seems little doubt that this regressive movement has increased and accelerated in the intervening years. One indication of this is the average weekly take home pay for a wage worker with three dependents. In real dollars, discounted for inflation, this amount dropped by 7 percent between 1972 and 1979. Between 1979 and October 1981, this amount dropped an additional 11 percent. There seems little doubt, based simply on last week's report of the record decline in average hours worked that the paycheck of the average wage worker is continuing to plummet.

In approximately one decade, inequality has grown and we have moved backward 25 years. In other words, the average American family has lost all the gains that have been made since the Eisenhower administration. Present trends and present policies, if allowed to continue unchecked, will result in our losing everything we have gained since the administration of Calvin Coolidge.

This is why I have characterized the present inequality crisis as not only disheartening, but dangerous. In recent weeks, we have all been reminded, I hope—as we reviewed the life and accomplishments of Franklin Roosevelt—that the unrecognized inequality crisis that characterized the 1920's led directly to the greatest economic crisis in our history, which almost broke our nation apart.

It is important to ask the question: how do we account for greater equality and inequality in our society? Let me suggest a hypothesis, I believe, well substantiated by the facts. We have moved toward greater equality when two conditions are present: the first is a Federal government that is relatively sympathetic to, and concerned about, the welfare of average working people; the second condition is that these people themselves demonstrate a determination to band together and fight for their own interests. This point is illustrated in two periods in recent history that have been characterized by rapid advances toward greater equality. The first is the period of the middle 1930's and the height of the New Deal, together with the concomitant upsurge in the organization of men and women into labor unions. A second example is found in the history of the 1960's. Again we find a Federal government clearly concerned about those who are less well-off, together with a high level of organized action directed toward civil rights, welfare rights, womens' rights, and the unionization of such relatively low-paid workers as hospital employees and employees of state and local governments.

Setbacks in the direction of greater inequality appear to occur during periods characterized by governmental hostility to the poor and to working people, by the suppression of organized activity through the means of high unemployment and high inflation, by overt and covert support of anti-labor activity and by neglect or active hostility towards efforts to end racial and sexual discrimination.

There are five components of the policy of the present administration that, if not opposed quickly and firmly, will exacerbate the growth of inequality in America. The first is the most obvious: the new and grossly unfair tax policy of the present administration, that will further enrich the wealthy and the great corporations at the expense of working people, small businessmen and other members of what I have called the vulnerable majority. Many of us made those charges when this policy was first proposed and now the charges have been amply confirmed by the famous Stockman interview in The Atlantic. Furthermore, recent polls suggest quite clearly that the American people are grasping the fact that this administration is giving unfair advantages to the rich.

It is worth pointing out that this large-scale experiment in so-called supply-side economics was actually given a test on a somewhat smaller scale during the 1970's. As I pointed out before, during these years there was a huge redistribution of income from the average American family to those who were already well-to-do, a transfer that, by 1978, amounted to an annual shift of over 60 billion dollars. At the same time after-tax corporate profits ballooned from 37 billion dollars in 1970 to 144 billion in 1979, more than 100 percent increase even after allowing for the inflated dollars. Such an enormous redistribution should, one would think, according to supply-side theory, have produced at least a small miracle of increased investment and productivity. No such supply-side miracle occurred. And I believe the consensus is growing that there will be none this time, either. It may well be true that faith can lead to miracles. It does not appear to be true in this case. And faith in self-proclaimed miracle-workers tends to disappear when no miracles are forthcoming.

The first order of business, then, in starting to do something about the inequality crisis, is to reestablish the time-honored American principle that everyone should pay his fair share of taxes. In the opinion of most people, that principle should apply to the rich as well as to the rest of us.

The second policy that is exacerbating the inequality crisis is cutbacks in social welfare and social insurance. We are already seeing the terrible effects of the first round of cuts affecting huge numbers of people. Last week's Newsweek poll indicated that nearly a third of all respondents said that they or their families have already been directly hurt by cuts in government spending. We see it all around us. Men and women are running out of their entitlements to unemployment compensation. Cuts in nutrition, health, fuel assistance, job training and welfare programs are driving more and more people back down below the poverty line. Despite repeated promises to leave Social Security alone, there have even been cuts in that most basic and trusted of American institutions.

Now we are being presented with proposals for further cuts that are truly incredible. If these proposals are not rejected out of hand, we will not be confronted simply by new statistics to argue about as to how many more millions have been improverished. Rather, this is a matter of life and death. These cuts in social programs will be th direct cause of deaths of human beings. Certainly thousands will die, perhaps tens of thousands. I would like to know what is in the minds of the leaders of this new form of class warfare of the rich against all the rest of us. What, in their view, is the acceptable level of casualties? How many of us do they think are expendable?

The third important policy to be considered is the blatant and insensitive abandonment of efforts to end continuing discrimination. To justify this abandonment, a mythology is being carefully cultivated that improvement in the condition of women and of minorities can occur only at the expense of those of us who are white males. This is the precise opposite of the actual facts. The demonstrable reality is that movement toward racial and sexual equality goes hand-in-hand with, and is an inseparable component of, movement toward overall equality in the society. This does not occur at the expense of white males, but rather at the expense of the wealthy minority of the American population. To paraphrase an infamous remark, what is good for women and blacks and other minorities is good for America. After all these years of struggle, it is inconceivable that our government can abruptly turn its back on women and on racial and ethnic minorities. it cannot be allowed to happen.

The fourth component of the policies of this administration that will worsen the inequality crisis is the rapid reduction of regulatory efforts to protect the health and safety of the American people, particularly in the workplace, but also on the highway and in the very air we breathe. Illness, disability or death of a breadwinner are among the most common causes of insecurity and sudden economic distress that push so many members of the vulnerable majority under the waterline of poverty every year. To reduce the prevalence of these events and to provide methods of insurance against their consequences are among the most powerful means of stabilizing the economic security of average families. The dereguation mania of the present administration is particularly worrisome because there is some evidence that the rate of industrial illness and accident has already begun to creep slowly upward. For example this rate increased from 91 to 93 per thousand from 1975 to 1977. It is reckless and shortsighted to deliberately increase these risks, to which every working American is exposed daily.

Finally, let me turn to the aspect of policy that cannot be directly derived from budgets or economic reports—the unfashionable issue of morals and values. Permit me to address just two aspects of this process: first, the more obvious efforts to transform the philosophical foundations of American society; second, the more subtle efforts to establish a new and misleading vocabulary in order to shape thought and discussion about the issues.

In my opinion, the propaganda attack against traditional American values being conducted by this administration and by its idelogical supporters is the most dangerous aspect of the growing inequality crisis. The battlecry is "Get the government off the backs of the people", and, in this context, we hear trimphant descriptions of programs abolished, bureaucracies constricted, and dollars saved. At a deeper level, I would argue, these words are messages of division and incitements to mutual distrust. We are being encouraged to isolate ourselves, one from the other, and to grow suspicious of our fellow-citizens. The goal, we are told, is to free the American people from those who are unjustly or unneccessarily claiming federal benefits, thereby leeching tax money from the pocketbooks of the rest of us. These vaguely identified groups are referred to as "them" and we are repeatedly promised that this administration will hunt "them" down, root "them" out, and cut "them" off. The unmistakeable message is that getting rid of "them" will bring economic relief to "us."

But who fits into these various categories of "them?" It is technically true that we can choose to define *each* such category as a small minority of parasites on "us", the majority. However, when we take an overall look at the whole picture, we see that when we put all the "thems" together, when we add up all the categories that are actually or potentially in peril, "them" is really "us." In this way, the American people is being manipulated so as to divide itself into small groups that will fight among themselves for the constantly shrinking slice of the pie being served to the vulnerable majority.

So we see that the moral problem embedded in the philosophy of the new conservatism is far more serious than the fact that we are being cynically tempted to harden our hearts against one another, to take care of ourselves and let the other fellow worry about his own troubles. The greater moral danger—which is also a serious political danger—is that we are being told that we are not, in fact, one nation, not really a unified people, a people that is both responsible for one another and safe to trust one another. We are being presuaded that America is divided into "them" and "us" and that "we" must constantly be on guard against "them."

This transformation is being partially accomplished by the successful introduction of a new and apparently innocuous vocabulary, reflecting a new set of assumptions about appropriate relations between the government and the people. These assumptions and the accompanying vocabulary have begun to dominate social policy discourse. Let me discuss three examples from the new vocabulary: (1) "the truly needy;" (2) "the social safety net;" and (3) "compassion."

The term, "truly needy", necessarily rests on the assumption that there is a relatively small group of persons who, because of misfortune, disability, incompetence or age, are a separate category of the population in need of help, dependent and pitiful, while the rest of us are safe and secure. This is far from reality, a dangerous illusion. The truth is that the great majority of Americans are vulnerable to economic disaster as a result of such common unforeseeable and uncontrollable events as the breakup of a family, the death of a breadwinner, unexpected accident or prolonged illness, loss of a job and so forth. We are constantly vulnerable and we could quickly become one of those in need—moving from the category of "us" to the category of "them." Most of us are, at best, only four or five paychecks away from sudden economic distress. So, while it is true that, in any one year, a relatively small minority are what we would call "poor", over a span of five or ten years, the majority of us are constantly vulnerable to falling into that category.

The linked ideas of "compassion" and "safety net" grow out of similar assumptions. The direct implication is that so-called "safety net" programs—Social Security, Medicare, unemployment compensation, food stamps, and so forth—are to be seen as some form of charity for those unable to take care of themselves. This is a serious misunderstanding of these programs. Not only is this idea not true, it is insulting to millions of Americans. The great programs that are a direct or indirect legacy of the New Deal are emphatically not philanthropic programs for the poor unfortunates upon whom we are taking pity and showing our compassion. And certainly no one has ever before dared to define them as handouts to the lazy and improvident.

It is fashionable nowadays to scorn anything with a New Deal label as outdated and irrelevant. We hear it said that the solutions of the 1930's or the 1960's are not the solutions of the 1980's. Strictly speaking, this is in some sense true. However, it is worth pointing out that many of the solutions to the problems of the 1930's and of the 1960's have become such an integral part of American life that we no longer even think of them as "solutions." I refer to such solutions that we now take for granted as social security pensions, federal insurance of our bank accounts, unemployment compensation, programs for the blind and so forth. Other such programs would be considered obviously irrelevant to today's conditions. But this way of thinking completely misses the point. No one in his right mind would advocate a simple duplication and rerun of the New Deal in a literal way—reviving the CCC or the WPA and similar programs. That was not the meaning of the New Deal at all. Rather, the New Deal is more accurately understood as the time when most Americans saw, and took as their own, a vision of a new America. To achieve that vision, Americans made a compact among themselves. That compact is still in force and the core of it is that all of us, all Americans, will henceforth be concerned with one another, will worry about one another's problems and will take care of one another. This compact was not simply a turn toward greater "compassion." I do not wish to imply that compassion is not a high and noble virtue. But it is important to recognize clearly that the compact to which I refer was based, not on compassion, but on self-interest, and on a recognition of common social membership in a complicated society in which many things could go wrong unexpectedly. It was based on a recognition that we are all in the same boat and that we are all responsible for one another. This, not compassion, is the basic rationale for the development of programs by which we have determined to guard ourselves—all of us—against the normal, as well as the unexpected contingencies, risks, and disasters that most of us are, sooner or later, subjected to.

To talk about "compassion", about "safety nets" for the "truly needy" is to completely miss the point of what America has become since 1935.

The fundamental fallacy of the slash-and-cut, devil-take-the-hindmost philosophy of the Reagan administration, as illustrated for example in the bizarre budget proposals just put forward—their basic fallacy is the belief that America is nothing more than a collection of 220 million isolated persons, each individual out to take care of himself as best he can. This is a strange and barbaric vision of human society and, even if it were possible for such a society to exist, it would be a terrifying one in which to live.

America is, of course, far more and far greater than that image. We are not simply a disconnected horde of lone cowhands. We are an enormously complex and interrelated society, in which no individual, no matter how supernormal he might be, could conceivably even begin to take care of himself alone.

Knowing this, we cannot escape the further insight that, as individuals, we cannot live, and, as a society, we cannot survive, unless we clearly agree that all of us are and should be dependent upon one another, that we can and must trust one another, that we should and that we will help one another.

These most fundamental agreements are now under all-out attack and that means that America is in great peril. Because it is not only social programs, but the very moral ligaments of American society, that are being cut and slashed.

Representative REUSS. Gentlemen, we are grateful to you, and we now stand in recess until 2 o'clock this afternoon, when, among other things, Mr. Smith, we can ask Mr. Stockman whether it was, indeed, an overzealous, lower level bureaucrat in the Office of Management and Budget who did in the survey of income statistics. Thank you all very much.

[Whereupon, at 12:30 p.m., the committee recessed, to reconvene at 2 p.m., the same day, in room 1202, Dirksen Senate Office Building.]

AFTERNOON SESSION

OPENING STATEMENT OF REPRESENTATIVE REUSS, CHAIRMAN

Representative REUSS. Good afternoon. The committee will be in order for the continuation of the hearings on the state of the economy. I want to welcome two very distinguished public servants, Mr. Malcolm Baldrige, and our former colleague, Bill Brock. You are both doing a great job and we appreciate your being here.

I have asked Congressman Richmond to chair the session this afternoon, since I may have to be in and out. So, Congressman, would you please take over.

Representative RICHMOND [presiding]. Thank you, Mr. Chairman. I can't think of a meeting I would rather chair, because it is bound to be exciting, interesting, and informative.

We are very pleased to have Secretary Baldrige and Ambassador Brock and Under Secretary Olmer with us this afternoon. We only have you for an hour and a half, and we appreciate your time.

OPENING STATEMENT OF REPRESENTATIVE RICHMOND

Gentlemen, for almost four decades the United States has provided military, political, and economic leadership for the Free World. The military strength, the room for political accommodation, the ability to construct rules for international commerce have all depended on the vitality of the American economy. Throughout most of the postwar period, the international economy was of secondary importance to the United States—it was the occasional icing on our ever-growing domestic cake. Well, I think we all know that that era is over.

International economic policy has moved center stage in the attempt to restore the health of the American economy. There are a variety of initiatives that should be taken right now. Let me give you my own list of five areas I think that demand attention.

SHARE THE BURDEN BUDGET

First, we must have a macroeconomic policy that will take the pressure off of seriously overvalued dollars. That means bringing the budget deficit under control. My own "share the burden budget" is a long step in the right direction. I know we discussed my "share the burden budget" before, but certainly I will be glad to send you copies any time you would like them.

Second, we need to move the liberal trading order forward to open neglected markets. We must bring international services and trade-related investments into the body of rules that govern international commerce.

Third, we must have a trade policy that will preserve our existing strength in high-technology goods. There, of course, I think we all need to start worrying about the computer, the entire technology—computer chips, memory chips, and whatnot, where we seem to be losing the battle.

Fourth, U.S. international leadership requires a consistent East-West policy that is built around continuous consultation with our allies.

JAPAN

Finally, there is Japan. The Japanese success story is a justifiable source of pride to the Japanese. The Japanese success story, however, is not just a reflection of hard work, good management, and a nationwide quality circle. Japan has prospered in an international system that has been built by American initiative and maintained by American forbearance. In thousands of ways, Japan has not met its responsibility to the international system.

Japanese economic policy looks to exports for growth and shields its financial system from outside influences. The Japanese spend little on national defense or international assistance and regularly use trade barriers to help build new industries. Japanese protectionism hits hard at America's high-technology industries and our own agricultural strength.

Mr. Secretary, Mr. Ambassador, Mr. Under Secretary, many of us are out of patience. Decades of talking loudly and carrying virtually no stick at all simply does not add up to a credible trade policy. The greatest economic leverage we have against Japan is a large, open, tempting American market. Until the Japanese are willing to meet our competition on equal grounds in their own home market, we have no choice but to limit their access to our market.

Very soon I plan to introduce legislation that will present Japan with a choice of full, free, and fair competition or the need to look elsewhere to market a substantial portion of their industrial exports.

It is a pleasure to have you with us again. I know that all three of you have toiled long and hard to forge an effective trade policy for the United States. But I just don't believe that you have gotten the support that you should from some of our allies. Thank you very much.

To move us quickly to your statement and our questions, I would like to have my complete opening statement placed in the record, along with several others, so as not to take up your time.

[The opening statements of Representative Richmond, Senator Roth, Senator Abdnor, and Senator Hawkins follow:]

Opening Statement of Representative Richmond

For almost four decades, the United States has provided the military, political and economic leadership for the free world. The military strength, the room for political accommodation, the ability to construct rules for international commerce have all depended on the vitality of the American economy. Throughout most of the post-war period, the international economy was of secondary importance to the United States—it was the occasional icing on our own ever growing domestic cake. That era has come to a close. We can no longer rest quietly on our own, homegrown laurels.

In the 1970's, the United States became much more involved with an international economy that had itself become larger, more varied, and much more competitive. Export sales are important for a wide variety of manufacturing firms and vital for the health of our farm sector. United States foreign direct investments have continued to grow and the larger U.S. banks draw a substantial portion of their profits from overseas operations.

The importance of imports is now an every day fact of American commercial life. We look to foreign producers for roughly 40 percent of our oil needs and a long list of strategic and industrial raw materials. Overseas manufacturing firms have brought lower prices and stiff competition to the American market. Import penetration started with relatively simple, labor intensive goods such as shoes and television sets and moved on to large, basic industries such as steel and autos. In the 1980's the United States can expect foreign competition in the high technology fields where we have been dominant for decades. The domestic party is over.

American business can no longer simply focus on the safe harbor of the domestic market with only an occasional glance at international opportunities or problems. Manufacturing firms and a growing array of service industries must now think in terms of a global market of which the American market is only a part.

International economic policy has moved center stage in the attempt to restore the health of the American economy. There are a variety of initiatives that should be taken now. Let me give you my own list of five areas that demand attention.

First, we must put overall economic policy on the right course. I know that Ambassador Brock is doing a good job at the bargaining table and that Secretary Baldrige has the Commerce Department out in the international field with an eye to building new export markets for the United States. But the good you gentlemen are doing has been more than offset by a mix of monetary and fiscal polices that keep interest rates high and the dollar seriously overvalued. Until we bring the budget deficit under control, interest rates are likely to stay and the United States will continue to lose ground in its own market as well as overseas. My own "share the burden budget" is a long step in the right direction. I will see that you both are sent copies.

Second, the United States must continue to build the liberal trading order. In the post-World War II era, the relatively free flow of goods and capital has made a major contribution to an unprecedented period of growth in the industrial west and in many parts of the developing world as well. New initiatives need to be taken to bring trade in services and trade related investments into the broad body of rules that govern international commerce. The United States will again have to take the lead role. At the same time, we have to recognize that our leadership has depended on a growing economy. To keep that economy growing we will have to get as much as we give in future trade negotiations. In some places, we will have to push to open markets that we neglected in the past.

Third, U.S. trade policy has got to be tailored to our industrial future. Japan, Europe and many developing countries are building high technology industries with substantial government assistance in essentially closed markets. We must counter that thrust.

Fourth, U.S. international leadership requires a consistent East-West commercial policy. Most of the high technology goods we manufacture are available elsewhere in the free world. Even our pre-eminent position in agriculture can be at least partially offset by expanded grain production in Australia, Argentina, Brazil, and elsewhere. We have to consult with our allies in order to build a unified Western position.

Finally, there is Japan. I have saved the trade problem requiring the most immediate attention for last. The post-war performance of the Japanese economy is nothing short of astounding. Unlike many prosperous countries, Japan has neither extensive agricultural resources nor great mineral wealth. Their economic strength has been built by reliance on the one resource they do possess—their people.

The Japanese success story, however, is not just a reflection of Japanese hard work, good management, and a nationwide quality circle. Japan has prospered in an international system that has been built by American initiative and maintained by American forebearance. In myriad ways, Japan has not met its responsibilities to the international system.

Look at overall Japanese economic policy. A "go slow" domestic growth strategy encourages Japanese industries to rely on export markets. By keeping their domestic financial system relatively closed to the rest of the world, Japan has been able to keep their interest rates well below those found in truly international markets.

The Japanese spend relatively little to keep the rest of the international system afloat. For instance, while the United States spends more than 6 percent of its GNP on national defense, Japan spends less than 1 percent. If U.S. defense spending were concentrated on capital investment, modernization, research, and export development, the world competitive situation would be very different today. Japan has simply got to do more on defense, on foreign assistance, on balance of payments support on accepting imports from the developing world.

Japanese trade policy has been a systematic violation of the letter and the spirit of the General Agreement on Tariffs and Trade. In Japan, trade policy is but one facet of an overall industrial strategy—not a set of laws that are in harmony with the needs of a broader international system. The past pattern of cosseting new industries with trade protection and coddling them with government support has been extended to semi-conductors, computers, and the full range of sophisticated electronic products. Japan intends to develop its own aircraft industry and has already started the move into bio-engineering. The areas of our greatest industrial strength are just where Japanese protection is most formidable.

Where Japan does import, the strategy is to capture as much of the processing for the Japanese market. They import timber, not lumber, hides not tanned leather, soybeans not soy sauce. The Japanese are the single largest consumer of U.S. agricultural goods—but even here they pepper their trade with barriers against U.S. citrus, beef and other products. The Japanese could buy American rice for a fraction of the price it costs to produce their own.

Japanese agricultural protectionism grows out of the political system of post-war Japan and the political needs of the ruling Liberal Democratic Party. The Japanese people have moved to the city but the voting power has stayed in the country. In effect, we are paying the economic price of Japan's refusal to reapportion its legislature.

The litany of tension between the United States and Japan is nothing new—it could have been written five or even ten years ago. The Japanese response has been one of piecemeal retreat—conceding a skirmish here, a small battle there all with an eye on winning the industrial war. The latest charade took place last week, when the Japanese took some action on a list of 99 complaints registered by the United States, the Common Market and some of Japan's other trading partners. U.S. sake and metal baseball bats will now receive a slightly deeper bow at the Japanese customs shed. Not surprisingly, no action was taken on agricultural quotas. The whole package amounts to little relative to the staggering bi-lateral trade deficit that we have with Japan.

Mr. Secretary, Mr. Ambassador, I am out of patience. Decades of talking loudly and carrying virtually no stick at all simply do not add up to a credible trade policy. The greatest economic leverage we have against Japan is the large, open, tempting American market. Until they are willing to meet our competition on equal ground in their home market, we have no choice but to limit their access to our own. I am introducing legislation later this month that will present Japan with the choice of full, free, and fair competition or the need to look elsewhere to market a substantial portion of their industrial exports.

It is a great pleasure to have you both with us again. I know you have both toiled long and hard to forge an effective trade policy for the United States.

Opening Statement of Senator Roth

It is a pleasure to see our trade spokesmen here today. They are appearing before this committee none too soon, as we are facing some important and pivotal decisions in the international trade arena.

The United States has long been the most open major market in the world. Merchandise from around the globe fills our stores and homes; foreign suppliers enjoy the same opportunities to operate and to sell their services within our borders as U.S. producers. The flow of foreign investment and capital remains relatively unfettered by government regulation or restrictions.

The same is not true elsewhere. In fact, it has never been true, even though the United States has operated on the philosophy that, by setting the example of free trade for the rest of the world, we will benefit as others follow our lead. Instead, we find ourselves in the position of the general who rode bravely into battle only to find his troops had marched off in another direction.

It was the United States that initiated successive rounds of multilateral trade negotiations under GATT aimed at reducing trade barriers and developing internationally agreed upon rules of trade conduct. The most recent round of these negotiations would have derailed in 1978 if our Special Trade Representative, Robert Strauss, had not been able to pull the pieces together again. Thanks largely to U.S. prodding, 99 countries in the international trading community concluded tariff agreements and codes on a wide range of nontariff measures, including subsidies, discriminatory Government purchasing practices and trade-distorting import licensing procedures. I enthusiastically supported these agreements in the belief that they would further open worldwide trade.

The United States has signed these codes and cut its import duties, urging its trading partners to do likewise. Some did—and some did not. Once again, we took a major step toward opening markets; and, once again, others failed to follow our lead.

For years, the international trading system has been based on the principle that no country should be accorded less favorable treatment than that given our "most favored" trading partner. While I have been a strong supporter of the most-favored-nation principle, I have found that, with each round of negotiations, the MFN treatment accorded by the United States is far more favorable than that granted by our trading partners.

While we have opened the lucrative U.S. Government purchasing market to foreign suppliers, oversea governments continue to buy national. While we have assiduously avoided the use of agricultural export subsidies, the European Community has embraced them as a centerpiece of the common agricultural policy. While we have rejected the widespread use of import quotas, the Japanese maintain numerous quantitative barriers on a wide range of farm products. In services and investment as well, the United States has kept its markets open, while U.S. exporters and investors face mounting and increasingly complex discriminatory actions overseas.

I believe strongly in free trade. Freedom in the international marketplace means lower prices, greater choice, and the opportunity to increase production. The resulting economies of scale enable us to supply a global, not just a domestic, market. But we cannot carry the free trade banner by ourselves.

Open markets in the United States, coupled with closed markets overseas, have had damaging side effects for U.S. producers. Faced with increasing foreign competition, U.S. carbon steel manufacturers have scaled back production to 55 percent of their industry's capacity. Our auto producers are in dire straits and have been forced to lay off workers from coast to coast. In my own State of Delaware, Chrysler and General Motors, faced with mounting inventories and growing competition, have had to close down some production lines.

In short, U.S. workers and firms are suffering because our trading partners refuse to play fair.

In recent days, this inequity has produced a good deal of discussion about reciprocity. Whether the term reciprocity is taken to mean fairness, or equivalent market access on a sector-by-sector basis, or equity, or overall trade-in-balance, I believe the time has come for serious consideration of this principle.

This consideration need not mean that we contemplate the overthrow of the international trading system. It need not mean the end of most-favored-nation treatment. It need not mean protectionism. It need not mean closing our markets in response to closed markets overseas. Rather, when I speak of reciprocity, or include the concept of fairness as a basis for making decisions on trade in U.S. services—as I have done in my Trade in Services Act of 1982 (S. 2058)—I mean a new approach to trade that will encourage others to open their markets as ours have been open for years.

It is time, then, for a fresh look at the rules of the international trading game. The United States will continue to benefit from free trade only if we can convince our trading partners to ease their barriers and restrictions as well. Reciprocity may seem to be a drastic approach, but nothing less drastic has worked so far.

Opening Statement of Senator Abdnor

Over the last several weeks I have asked administration officials to try and visualize the condition of the U.S. economy today without the contributions of the American farmer.

What kind of an inflation rate would there have been in 1981 had farm prices not plummeted?

How many millions of jobs would be lost in the growing, storing, transportation, processing, merchandising, and marketing of food alone if the United States was not the leading and most efficient food growing nation in the world?

What would the impact on savings and investment be if American consumers did not devote 16 percent of their income, as they do, to food purchases, but rather had to devote 20 or 30 percent such as consumers in Western Europe pay?

The topic today is U.S. international trade policy. U.S. agricultural exports have climbed from $7.0 billion in 1970 to $43.8 billion in 1981, a 526 percent increase. Agricultural imports during this same period, however, increased by only 202 percent, from $5.7 billion to $17.2 billion. Agricultural exports as a percent of total U.S. exports were 16.8 percent in 1970 and 19.1 percent in 1981. As a further contribution to our economic viability, agricultural imports as a percent of total U.S. imports declined from 14.6 percent in 1970 to 6.7 percent in 1981. Had agricultural exports grown at the same rate as all other U.S. commodity exports we would now be looking at a 1981 trade deficit of over $40 billion rather than $26 billion. I shudder to think of the economic implications of that. For fiscal year 1982 the Department of Agriculture forecasts an export value of $45.5 billion, less than a 4 percent increase over 1981. In order to accomplish this, according to the USDA America will have to export 10 percent more commodities. This is because prices are expected to decline by 6 percent.

If this agriculture forecast proves correct, what other export sector of our economy can pick up the slack? How will we prevent a further deterioration in our already embarrassing balance of trade?

Thank you.

Opening Statement of Senator Hawkins

The United States is up against a number of difficult problems in the trade area. Preliminary 1981 figures show a total trade balance deficit of $26.3 billion, the second largest annual deficit in our history. As a matter of fact, during the last 10 years, only in 1975 did we have a trade surplus and then it only amounted to $5.2 billion. The 455 percent increase in the value of all U.S. exports since 1970 is unfortunately overshadowed by a 554 percent increase in the value of our imports.

We must export more industrial and more agricultural products.

Yet America faces severe competition from highly productive foreign producers and, in many cases, American products are discriminated against through the use of artificial foreign trade barriers.

Japanese automobile exports to the United States have tripled in the past 10 years. In 1980, Japan exported 54 percent of the approximately 11 million cars, trucks, and buses that it produced. Both West Germany and France exported over 50 percent of the 7.1 million autos, trucks, and buses they produced. The United States on the other hand, exported 9.5 percent of its 8 million units produced. If we are to compete we must increase our product quality at the same time as we increase productivity. And I would emphasize that Americans will not shrink from a fair challenge.

Obviously I could continue to recite this kind of depressing statistic. I think it is time for a positive change in our strategy. We must develop productivity improvement programs and, as part of this, begin an earnest search for an effective way to collaborate on industrial production with the Japanese. And we must be firm in our negotiations over foreign trade barriers. America cannot be expected to stay a dumping ground for foreign products.

Representative RICHMOND. Senator Jepsen, it is a pleasure to see you—our distinguished vice chairman.

Opening Statement of Senator Jepsen, Vice Chairman

Senator JEPSEN. It is a pleasure to see you. Thank you.

It is a pleasure to welcome Secretary Baldrige and Ambassador Brock to this hearing on U.S. trade policy. Trade is a growing portion of our national economic accounts, providing jobs for Americans, holding down inflation, and giving our consumers the widest possible choice in their purchases of goods and services.

I am, therefore, heartened to see this administration place such a high priority on free trade and expanding trade opportunities.

I am glad Ambassador Brock and Secretary Baldrige have placed such importance on removing many of the unnecessary barriers to U.S. exporters. Restrictions arising from the Foreign Corrupt Practices Act, certain antitrust regulations, and U.S. tax laws have traditionally discouraged exporting. Congress and the President have revised the tax laws—it is now time to eliminate the remaining export barriers.

AGRICULTURAL EXPORTS

One area that deserves much of the recognition for our domestic economic and international trade growth is American agriculture. Agriculture is a trillion-dollar industry whose activities contribute

20 percent to our gross national product and provide 23 million jobs.

On the international front, at a time when overall merchandise trade is suffering severe imbalances—to the tune of $28 billion on a balance of payments basis for 1981 alone—agriculture continues to show up in the black. Last year, overall agricultural exports topped $45 billion.

Foreign markets are critical to U.S. farmers. We export 36 percent of our corn production, 64 percent of our wheat production, and 40 percent of our soybean output. Over the past decade, the United States accounted for three-fourths of the increase in world grain trade.

Clearly, without these foreign markets, our farmers would be in serious trouble.

FOREIGN TRADE RESTRICTIONS

We have witnessed an increasing tendency among our trading partners, however, to steal markets away from U.S. producers by means of unfair export subsidies, and other incentives. The European Community, for example, provides a wide range of export aids and refunds to farmers who then undercut U.S. prices in third markets.

Japan makes a more direct route, severely restricting imports of agricultural goods into its own market by the use of quotas.

Should other countries follow Europe's and Japan's lead, we will shortly find ourselves with no place but home to sell our growing farm output.

In response to this danger, I call upon this administration to step up its efforts to obtain free world trade in agricultural, as well as industrial products.

REJECT EXPORT EMBARGOES

As part of this effort, I strongly believe our witnesses today—indeed the entire administration—should reject the use of agricultural export embargoes. Restricting our own exports to achieve unrelated foreign policy objectives is just a way of shooting ourselves in the foot. And restricting farm exports in particular inflicts severe hardships on our farmers, their families, and this Nation as a whole.

If, under the direst circumstances, embargoes must be imposed on U.S. trade, I believe they should be imposed across the board. My colleagues agree. In the 1981 farm bill, the Congress included my provision requiring that, if embargoes are imposed on farm products alone, farmers will have to be compensated fully for loss of markets.

This is a powerful provision and one that should not be taken lightly.

American agriculture is strong, but it will not remain strong unless it is free to sell in the world marketplace without fear of preemptive embargoes.

I trust our witnesses today will agree and will continue their efforts to enable all U.S. trade—agricultural as well as industrial—to flow freely and earn the best possible return for the U.S. economy.

Gentlemen, we welcome you to this committee.

Representative RICHMOND. Thank you, Mr. Vice Chairman. Now we turn to Secretary of Commerce Baldrige.

STATEMENT OF HON. MALCOLM BALDRIGE, SECRETARY OF COMMERCE, ACCOMPANIED BY LIONEL OLMER, UNDER SECRETARY FOR INTERNATIONAL TRADE

Secretary BALDRIGE. I am pleased to appear here before the Joint Economic Committee with Ambassador Brock to discuss U.S. trade policy. I will comment on the world trade situation and the increasing pressures for turning to trade protectionism. I will also focus on the issues of U.S. competitiveness, especially in high-technology fields; East-West trade; and Commerce trade promotion programs.

WORLD TRADE SITUATION

The world trade situation has been aggravated by the severe, worldwide economic recession. International trade is being subjected to new stresses, which threaten the extensisve liberalization of trade that has taken place since World War II. Already there has been a dramatic slowing in merchandise trade among the nations of the world. Last year, for the first time in three decades, the trade of the free world declined in real terms.

Historically, in times of recession, strong pressures develop for protectionism and the restriction of trade. To bolster their economies, many of our trading partners are resorting to new or expanded protectionist measures to limit imports and to expand exports through government-backed export incentives. These include trade-related performance requirements and restricted import levels.

Added to these difficulties are continuing distortions in trade resulting from past restraints, such as the use of nontariff barriers by some of our major trading partners. There is no question that the United States is demonstrating a greater commitment to a fair and open trading system than any major country in the world. How long we can continue to sustain this traditional role is getting to be an increasing question if other countries pursue their self-interests to our detriment.

U.S. COMPETITIVENESS AND HIGH TECHNOLOGY

U.S. trade data, market share figures—particularly for manufactured exports—and long-term indicators of industrial competitiveness show that our economy is falling behind our major competitors. Due to lower U.S. investment in plant and equipment and a smaller share of R. & D. spending than our competitors, productivity growth in the United States has been unable to offset a larger portion of wage increases as it has in other countries.

The bright spot in U.S. competitive performance and trade is trade in high-technology products. Since 1975 we have had a cumulative surplus of $128 billion in high-tech trade, compared to the cumulative surplus of $148 billion deficit in overall merchandise trade. In the last 2 years our surplus in the high-technology area has exceeded $60 billion.

But, if we look into the future we face a very broad challenge of other countries in the high-technology area, including foreign government subsidized research and development and export support programs.

The implications of this trend indicated that we urgently support our high technology industries and what must be done to maintain their preeminence.

Because of the importance of high-technology trade, in December the Cabinet Council on Commerce and Trade, authorized a study on the competitive position of U.S. high-technology industries.

The efforts of this administration to solve the problems of the high-technology sector are being taken within the framework of our overall policy of free trade. The world system of free trade demands that all nations follow common principles of fairness. And fairness in the trading relations among nations includes the concept of reciprocal treatment. Let me assure you reciprocity does not mean protectionism in this sense. It means the demand for equivalent access to the markets of our trading partners.

EAST-WEST TRADE POLICY

Let me move, if I may, to East-West trade. This administration took office with the clear determination to protect vital U.S. and free world interests in the management of our commercial relations with Communist nations. We have placed the highest priority on the need to establish a consistent and predictable policy which will take into account the security, foreign policy, and economic conditions which exist today. As an element of that effort, we streamlined the export license processing system. We had a 2,000-case backlog when I took office. It is down to practically zero now.

This administration has made clear from the beginning that our approach to trade with the Soviet Union must be consistent with our political and security objectives. We are prepared to continue and expand our trade in nonstrategic areas if the Soviets act responsibly and with restraint in the international arena.

In December, martial law was declared in Poland; the repressive role of the Soviet Union in this situation called for a firm response. We, therefore, have imposed selected economic sanctions against the Soviet Union and Poland.

At the same time we have sought to limit adverse effects on U.S. business and jobs that result from this action. Our business community has been generally understanding of our need to impose sanctions, our allies agreed not to undercut our actions by providing alternate sources. We view this as a commitment to restrain their companies which otherwise might take commercial advantage of this situation.

In the area of strategic militarily relevant dual-use technologies and equipment, we and our allies have begun improving the system of multilateral strategic controls that govern Western exports to the Soviet Union. We now have a political commitment within Cocom which provides the foundation for refocussing and strengthening international control efforts toward critical technologies and equipment. We also look toward streamlining and strengthening the rules and procedures which guide our joint efforts and a more coordinated and aggressive control enforcement effort.

Finally, this administration has moved ahead vigorously to normalize our trade ties with the People's Republic of China. In July 1981, the President announced a new and more liberal export policy toward the PRC. This new policy is consistent with our mutual security and economic interests and increasingly friendly relations with the PRC.

TRADE PROMOTION

Expanding exports remains a key component of the administration's economic recovery program. Export expansion means increased U.S. jobs, higher profits for U.S. business and a stronger national economy. The Department of Commerce has implemented a number of programs in pursuit of that goal, and others are being developed. Management changes and realinements have resulted in a leaner, more efficient organization, able to do more with less.

Major emphasis has been put on "reaching out" to involve more businesses, particularly small and medium-size ones, in exporting. At the same time increased cooperation with State and local governments and private sector organizations have broadened the base of support for this export activity.

By encouraging the private sector to take a larger part in export assistance activity, we are focusing Government resources on areas where they can really make a difference. With the passage of the Export Trading Company Act, which we hope the Congress will bring about this session, our business community will then have access to the kinds of assistance so effectively used by most of our major competitors.

One recent example of our new market promotion efforts was our highly successful high-level U.S. Trade and Investment Mission to Africa, which visited the Ivory Coast, Nigeria, Cameroon, and Morocco. Agriculture Secretary John Block and I led a group of 25 corporate executives of U.S. companies in agribusiness, agricultural commodities, construction, mining, and telecommunications fields. Other Government participants included the Chairman of the Export-Import Bank, the President of OPIC, AID's Assistant Administrator for Private Enterprise and State Department officials.

The African governments and the local business communities warmly received us. In less than 2 weeks our business members submitted proposals and signed feasibility study agreements and contracts worth more than $170 million. They developed numerous other business and investment leads which they plan to pursue. We feel that this mission was an unqualified success for American business and our quality products and technology.

If I may, Representative Richmond, I would like to include for the record, a copy of the letter that all 25 of these businessmen signed, to the President of the United States, on their return.

Representative RICHMOND. Without objection, Mr. Secretary.

Secretary BALDRIGE. Let me close by emphasizing the importance to the U.S. economy of expanding U.S. trade opportunities. To do this we must continue to work for an open and fair trade system; to maintain and expand our competitive support position especially in high-technology exports; and to pursue trade policies that are consistent with U.S. security, political interests, and economic needs. We have the products, the technology, and the resources to be the strongest trading country; and with will and dedication to the job at hand, we will continue these strengths into the future.

Thank you very much, Congressman.

[The addendum to Secretary Baldrige's statement, together with the letter referred to, follows:]

ADDENDUM TO THE STATEMENT OF HON. MALCOLM BALDRIGE

UPDATE OF U.S. FOREIGN TRADE DEVELOPMENTS
FULL YEAR 1981

Introduction

In 1981, the U.S. merchandise trade deficit increased from the preceding year for the first time since 1978. Imports (valued f.a.s.) exceeded exports by $27.6 billion in 1981. The growth rates of both exports and imports slowed markedly last year. Exports increased to $233.7 billion, a gain of only 5.9 percent in 1981, compared to a 21.3 percent increase in 1980. Imports climbed to $261.3 billion, a rise of only 6.7 percent last year, following a 16.9 percent rise in 1980.

In 1981, there was a relatively small deterioration in the U.S. trade position of $3.4 billion despite sluggish foreign economic activity, a sharply appreciated dollar, and faster growth in nonpetroleum imports. Nevertheless, the size of the trade deficit remains a matter of serious concern. Last year marked the fifth consecutive year in which the deficit exceeded $20 billion, a period during which the cumulative imbalance totaled $140 billion.

The outlook for 1982 is for a further deterioration in the trade deficit based on a current reading of domestic and foreign economic prospects. Continued slow economic growth abroad and the lagged effect of a stronger dollar will constrain export growth and offset the decreased import demand resulting from a sluggish U.S. economy. The recovery in the U.S. economy expected later in 1982, moreover, will probably stimulate a resumption of import growth in the second half. The bilateral trade deficit with Japan, which was $16 billion in 1981, will widen to $20 billion or more in 1982 and account for more than half of the overall 1982 deficit.

General Trends in 1981

Growth rates for both exports and imports last year were comparatively low, reflecting the significant downturn in U.S. and foreign economic activity since early in 1980 and, on the import side, the reduction in U.S. demand for imported petroleum. These low rates of growth contrasted sharply with the 18-27 percent annual increases in exports and 16-20 percent increases in imports recorded in the preceding three years.

The deterioration in the U.S. trade balance this year was masked to some extent by a substantial reduction in petroleum imports since the beginning of 1981. The decline in these purchases, which account for nearly one-third of our total imports, have partly offset a substantial rise in imports of manufactured goods and other nonpetroleum products. Moreover, although exports rose rapidly in the early months of 1981, the trend since March was generally downward for both manufactured goods and agricultural products. Thus, the deterioration in the manufactures trade balance this year has been greater than the deterioration in the overall trade balance. The trade surplus in manufactured goods dropped to $11.7 billion in 1981 compared to $18.8 billion in 1980. Exports of manufactures increased by 7 percent, only one-third as fast as in 1980. Imports of manufactures, however, actually picked up momentum -- rising 14 percent in 1981 following a 11 percent increase in the preceding year.

Export Highlights

The slowdown in manufactured goods exports mainly reflected sluggish economic conditions in foreign countries and the substantial appreciation of the value of the dollar. Most major categories of exports recorded less rapid increases in 1981: machinery, chemicals, aircraft, coal, and other industrial materials as a group. Automotive exports (mainly to Canada) posted a modest recovery, however. Despite the interruption of shipments during the coal strike March 7 to June 27, coal exports rose strongly last year, by 28 percent to $5.9 billion. After averaging a 20 percent yearly increase in 1977-1980, agricultural exports rose only 5 percent last year. All of the increase stemmed from higher average prices which more than compensated for a drop in the volume of exports.

Import Highlights

The rise in U.S. imports in 1981 was almost entirely attributable to greater imports of manufactured goods. The major increases were recorded in steel, chemicals, various types of machinery, and clothing. Imports of passenger cars from Japan increased in value by 16 percent (although declining 6 percent in quantity), but this increase was largely offset by a decrease from other overseas suppliers. Steel imports jumped 55 percent in value. Although some of this expansion represented higher average prices, there was a substantial increase in the volume of imports as well, particularly after the first quarter. Compared to the 1980 level, steel imports rose 30 percent in quantity.

The major import change was a drop in the value of petroleum imports. Petroleum imports declined by 2 percent in 1981 to $76.7 billion, reflecting a 13 percent drop in quantity. In terms of barrels per day, 1981 imports were 6.1 million versus 7.0 million in 1980. The average price of petroleum imports was $34.31 per barrel in 1981, up 12 percent from the $30.65 level recorded the previous year.

Regional Trade Developments

A favorable development in terms of its impact on the total deficit was the marked improvement last year in the U.S. trade deficit with OPEC. In 1981, our deficit with OPEC was $27.9 billion, a nearly $10 billion reduction from the 1980 deficit. Of course, the reduced prices and volume of crude petroleum imports have been the key factors in this improvement.

In contrast to the reduction in the U.S. deficit with OPEC, our bilateral trade deficit with Japan widened sharply in 1981, reaching $15.8 billion, a $5.9 billion increase from the previous year's deficit.

Exports to Japan climbed by only 5 percent last year as reduced exports of crude materials such as lumber and steel scrap offset large increases in agricultural exports, and large manufactures exports as well. Imports from Japan, on the other hand, continued to rise strongly in 1981, climbing 22 percent to $37.6 billion.

At the same time, our traditionally large surplus with Western Europe narrowed substantially, to $13.5 billion in 1981 from $20.8 billion in the preceding year. This development mainly reflected an absolute decline in exports; the 3 percent decrease represented the first drop in sales to Europe since 1971. Imports from Western Europe continued to increase in 1981. The 11 percent increase in these imports last year was about the same rate of increase recorded in 1980.

U.S. - REGIONAL TRADE SUMMARY TABLE
DECEMBER 1981
EXPORTS: Millions of Dollars, f.a.s., Seasonally Adjusted Data
IMPORTS: Millions of Dollars, f.a.s., Seasonally Adjusted Data

	DEC 81	NOV 81	Annual Data 1981
EXPORTS TO JAPAN	$ 2,102	$ 1,942	$21,823
% Change from Prior Period	8.3%	6.8%	5.0%
IMPORTS FROM JAPAN	$ 3,047	$ 3,381	$37,612
% Change from Prior Period	-9.9%	-9.9%	22.5%
BALANCE	-$ 945	-$ 1,439	-$15,789
$ Change from Prior Period	$ 494	$ 493	-$ 5,865
EXPORTS TO CANADA	$ 2,912	$ 3,210	$39,564
% Change from Prior Period	-9.3%	14.4%	11.8%
IMPORTS FROM CANADA	$ 3,526	$ 3,969	$46,414
% Change from Prior Period	-11.2%	-1.2%	12.0%
BALANCE	-$ 614	-$ 759	-$ 6,850
$ Change from Prior Period	$ 145	$ 472	-$ 786
EXPORTS TO THE EUROPEAN COMMUNITY	$ 4,193	$ 4,269	$52,363
% Change from Prior Period	-1.8%	-0.7%	-4.1%
IMPORTS FROM THE EUROPEAN COMMUNITY	$ 3,419	$ 3,527	$41,624
% Change from Prior Period	-3.1%	-2.9%	14.4%
BALANCE	$ 774	$ 742	$10,706
$ Change from Prior Period	$ 32	$ 75	-$ 7,511
EXPORTS TO OPEC	$ 1,830	$ 1,806	$21,533
% Change from Prior Period	1.3%	-3.1%	21.3%
IMPORTS FROM OPEC	$ 3,046	$ 4,153	$49,442
% Change from Prior Period	-26.6%	7.2%	-10.6%
BALANCE	-$ 1,216	-$ 2,347	-$27,909
$ Change from Prior Period	$ 1,131	-$ 337	$ 9,646
EXPORTS TO NON-OPEC LDCS	$ 5,334	$ 5,229	$67,439
% Change from Prior Period	2.0%	-9.8%	6.4%
IMPORTS FROM NON-OPEC LDCS	$ 5,044	$ 5,630	$66,901
% Change from Prior Period	-10.4%	-12.4%	8.4%
BALANCE	$ 290	-$ 401	$ 538
$ Change from Prior Period	$ 691	$ 231	-$ 1,117

U.S. MERCHANDISE TRADE SUMMARY TABLE-DECEMBER 1981

EXPORTS: Millions of Dollars, f.a.s., Seasonally Adjusted Data
IMPORTS: Millions of Dollars, f.a.s., Seasonally Adjusted Data

	DEC 81	NOV 81	DEC 80*
TOTAL EXPORTS	$18,821.1	$19,117.7	$19,250.9
% Change from Prior Month	-1.6%	0.4%	-2.2%
MANUFACTURES EXPORTS	$12,245.4	$12,579.9	$12,367.9
% Change from Prior Month	-2.7%	2.0%	-1.0%
AGRICULTURAL EXPORTS	$ 3,235.2	$ 3,652.8	$ 3,843.0
% Change from Prior Month	-11.4%	-0.9%	-15.8%
TOTAL IMPORTS	$19,516.3	$22,521.5	$21,436.3
% Change from Prior Month	-13.3%	-3.1%	-9.0%
MANUFACTURES IMPORTS	$11,228.6	$12,823.3	$10,896.6
% Change from Prior Month	12.4%	-3.3%	3.1%
PETROLEUM IMPORTS	$ 4,970.9	$ 6,196.8	$ 7,093.4
% Change from Prior Month	-19.8%	-1.7%	-29.9%
TOTAL TRADE BALANCE	-$ 695.2	-$3,403.8	-$ 2,185.4
$ Change from Prior Month	$ 2,708.6	$ 786.7	$ 1,490.2
MANUFACTURES TRADE BALANCE	$ 1,016.8	-$ 243.4	$ 1,471.3
$ Change from Prior Month	$ 1,260.2	$ 679.6	-$ 454.5

* Changes in this column are year-over-year, DEC 80 to DEC 81.

	Annual Data 1981	Annual Data 1980
TOTAL EXPORTS	$233,677.0	$220,626.3
% Change from Prior Year	5.9%	- - -
MANUFACTURES EXPORTS	$154,282.7	$143,890.8
% Change from Prior Year	7.2%	- - -
AGRICULTURAL EXPORTS	$ 43,815.0	$ 41,757.0
% Change from Prior Year	4.9%	- - -
TOTAL IMPORTS	$261,304.9	$244,870.6
% Change from Prior Year	6.7%	- - -
MANUFACTURES IMPORTS	$142,543.7	$125,121.8
% Change from Prior Year	13.9%	- - -
PETROLEUM IMPORTS	$ 76,711.8	$ 78,636.8
% Change from Prior Year	-2.5%	- - -
TOTAL TRADE BALANCE	-$ 27,627.9	-$ 24,244.3
$ Change from Prior Year	-$ 3,383.6	- - -
MANUFACTURES TRADE BALANCE	$ 11,739.0	$ 18,769.0
$ Change from Prior Year	-$ 7,030.0	- - -

Figure A

U.S. TRADE BALANCES

Monthly Balances in Millions of Dollars
Seasonally Adjusted Data

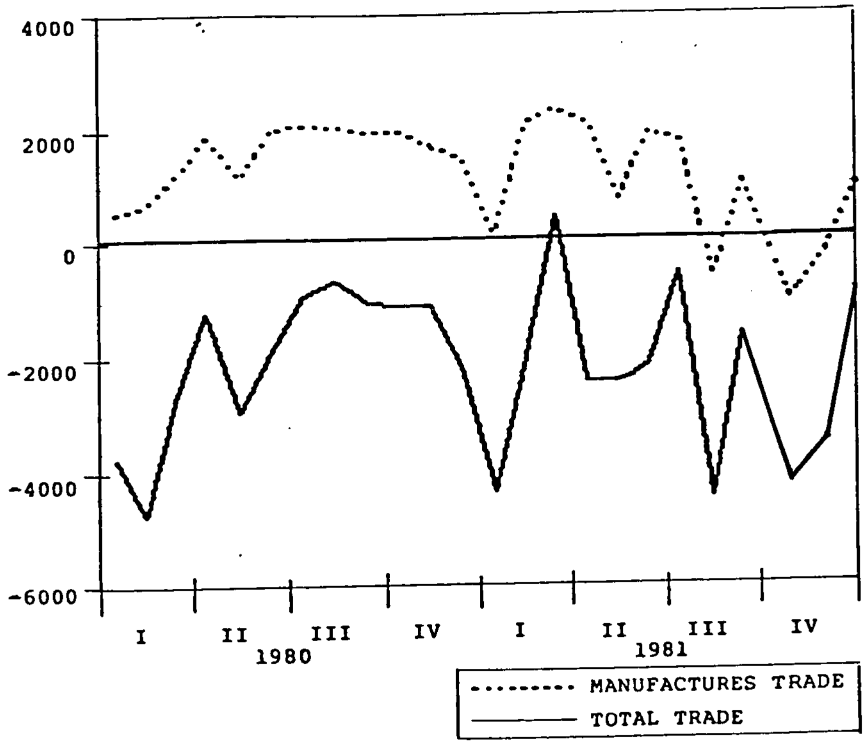


Figure B

U.S. TOTAL TRADE

Monthly Trade in Millions of Dollars
Seasonally Adjusted Data

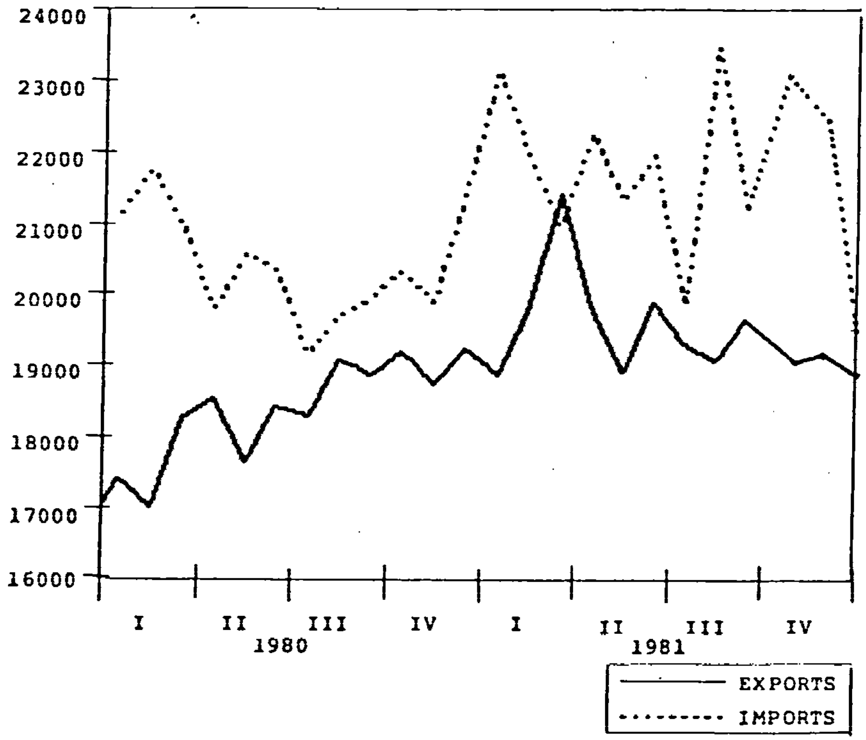


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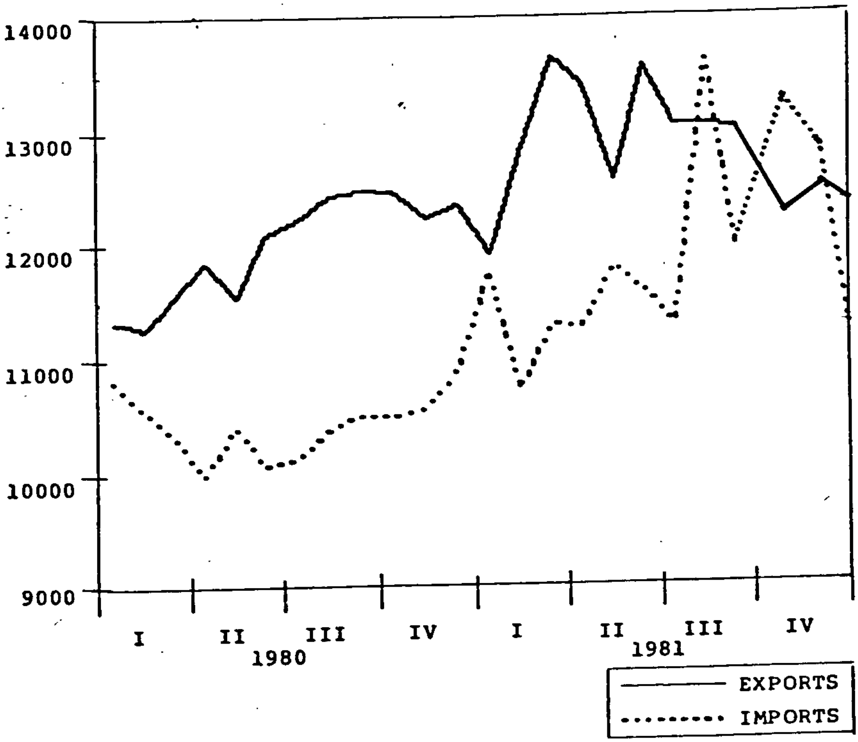
Figure C

U.S. MANUFACTURES TRADE

Monthly Trade in Millions of Dollars
Seasonally Adjusted Data



SYSTEMS
ARCHITECTS,
INC.

S.A.I. RESEARCH AND DEVELOPMENT PARK
THOMAS PATTEN DRIVE
RANDOLPH, MASSACHUSETTS 02368 (617) 961-4840

January 30, 1982

Ronald Reagan, President
The United States of America
The White House
Washington, DC 20500

Dear President Reagan:

We businessmen, as members of the recently completed United States Trade and Investment Mission to Africa, would like to congratulate you on this very significant step toward increasing our country's commercial relationships with Africa. We are confident that this mission will show the developing nations, and in particular Africa, that the principles you set forth at Cancun are being vigorously pursued by your administration.

Our experience on this mission has convinced us that the development of trade, the establishment of jointly-owned businesses, and the expansion of United States investment are the best ways to accelerate the development process in these countries. At the same time, we believe that it will contribute substantial benefits to the United States economy.

In this regard, we have identified many opportunities in each of the countries visited. We pledge to you our intention to produce concrete results through follow-up visits and our continued efforts.

We highly commend the efforts of Secretaries Baldridge and Block on this mission. They clearly demonstrated to the people of the countries visited, the sincere interest of the United States government and American business community in working with them. The warmth with which we were received was a direct result of their obvious sincerity and their tireless efforts.

We urge you to consider similar missions to other developing areas of the world. We are convinced that the cooperative efforts of the United States government and the American business community can, in fact, move mountains. The jobs that will be created by these ventures, both in the United States and worldwide, will go a long way toward alleviating our present economic difficulties.

In closing, we would like to commend all the government personnel who participated in this mission. The Washington staff members, as well as your Ambassadors and their staffs, dedicated themselves to ensure the success of our joint efforts.

Let us assure you that we businessmen will do our best to followup on this initial step so that this visit will mark the start of a new era in commercial relations with Africa.

Respectfully,

George S. Pan, Chairman Steering Committee
President,
Systems Architects, Inc.

J.D. Allen, President
J.D. Allen Industries, Inc.

Dr. Kenneth L. Badar, Chief Executive Officer
American Soybean Association

Admiral James V. Bartlett (Ret.)
Senior Group Vice President Engineering
Raymond International Builders, Inc.

Dr. Louis Berger, President
Louis Berger International, Inc.

Ambassador William G. Bradford, Partner
Concrete Housing International, Inc.

Frank E. Briber, Jr., President
Allis-Chalmers Corporation

Allan Clark, President
Trek Services Corporation

James F. Dempsey, Vice President-International
Air Products and Chemicals, Inc.

Paul Fayhee, Vice President
Midwest Ag. Trading Company, Inc.

Bill Goldsmith, Executive Vice President
Rice Council for Market Development

Joseph V. Guido, Vice President and Director
Latin American Operations
Motorola, Inc.

Alvan K. Gustafson, President and Chief Executive Officer
Fru-Con International, Ltd.

Theodore R. Hagans Jr., President
Fort Lincoln New Town Corporation

Samuel M. Harrell, Chairman and Chief Executive
Tidewater Grain Company

Francisco J. Hernandez, President
Agro Tech International, Inc.

Harold E. House, Executive Vice President
Louis Dreyfus Corporation

Arthur P. Ism[illegible], President
Gateway International Holdings, Inc.

Eugene D. Jackson, President
Unity Broadcasting Network, Inc.

George T. Lewis Jr., Group Vice President
Chas T. Main International, Inc.

Ambassador Armin H. Meyer, Director of International Relations
Ecology and Environment, Inc.

Joseph R. Perini, Senior Vice President and Treasurer
Perini Corporation

Thomas W. Read, Senior Vice President
Read Steel Products, Inc.

Milo Schanzenbach, Secretary-Treasurer
U.S. Wheat Associates, Inc.

Lewis R. Smoot Sr., President
The Sherman R. Smoot Company, Inc.

James S. Stotsky, Chief Executive Officer
T-CAS America, Inc.

Frank Travis
Frank Travis, Vice President, Middle East Africa Area
Ingersoll-Rand Company

Copies to: Alexander Haig, Secretary, U.S. Department of State

Malcom Baldridge, Secretary, U.S. Department of Commerce

John Block, Secretary, U.S. Department of Agriculture

Edward Meese III, Counselor to the President

James Baker III, Chief of Staff

Michael Deaver, Deputy Chief of Staff

Lionel H. Olmer, Under Secretary for International Trade, U.S. Department of Commerce

William H. Morris Jr., Assistant Secretary for Trade Development International Trade Administration, U.S. Department of Commerce

Robert D. Hormats, Assistant Secretary of State for Economic and Business Affairs

Elise du Pont, Assistant Administrator, Bureau for Private Enterprise Agency for International Development

William H. Draper III, President and Chairman, Export Import Bank of the United States

Craig A. Nalen, President and Chief Executive Officer Overseas Private Investment Corporation

Dr. Marilyn J. Seiber, Special Assistant to the Under Secretary and Deputy Misson Director

Representative RICHMOND. Thank you very much. Mr. Secretary. Ambassador Brock.

STATEMENT OF HON. WILLIAM E. BROCK III, U.S. TRADE REPRESENTATIVE

Ambassador BROCK. Thank you, Congressman.

I want to express my delight at being back before this committee, on which I served—very pleasant, productive years. I happen to believe this is far and away the most important joint committee that the Congress has, and I appreciate your interest in this subject.

When I came on my first visit about a year ago, I mentioned two priorities—first, that we had to act quickly and decisively to restore our own domestic economic health in order to be competitive. I think we laid down the foundation for that recovery with the action taken by the Congress last year.

Second, I suggested the need to preserve and strengthen the open and fair-trading system we have been constructing for 35 years, on which our prosperity depends.

The contribution of exports to domestic employment, agricultural production, corporate profits, and a strong currency require us to pursue further the reciprocal trade liberalization. Protectionism can only hurt us. It will damage American opportunities for strong export sectors. It will not provide revitalization of our presently weak sectors. I think those conclusions are no less true 1 year later.

The challenge of preserving and stengthening the system is perhaps even more critical today. There are an awful lot of factors, both positive and negative weighing on the world trading system. We are building some momentum to tackle some of the most restrictive practices still affecting world trade, particularly in the area of agricultural services and investment. But on the other hand, the failure of past efforts to open some foreign markets for U.S. exports is causing increasing frustration in the Congress and in the administration.

It is my own belief that the trade pressures generated currently are more intense than at any time certainly since the early 1970's. The causes of that frustration are very real.

The United States has the most open market in the world. The opening of our market, however, has been predicated on the expectation that similar opportunities would be created for U.S. exports abroad. Our legitimate expectations, however, have not been fulfilled.

TRADE RELATIONS WITH JAPAN

Worse still, protectionism seems to actually be on the increase in too many areas abroad, while in Japan we do have, as the chairman has stated, an unequal trading relationship.

U.S. producers who are competitive everywhere else around the world have made little headway in penetrating the Japanese market. But it isn't just U.S. producers, by the way. It's any other producer. Small countries, large countries all have the same access difficulty.

The Japanese economy continues to expand. This expansion, however, is based on increasing Japanese exports, while domestic demand for imports stagnate.

Our deficit, which appeared in 1981, is in the area of $16 billion on an FOB basis, well in excess of $19 billion on a delivered basis, and may and probably will be worse in this year.

Japan, on the other hand, will run a surplus in its merchandise trade of about $21 billion in 1981, as much as $35 billion in 1982. Additionally, the surplus in Japan's current account is expected to triple this year, from $5.5 billion to $17 billion.

The announcements of Minister Abe about the reduction of many import barriers is encouraging. However, these measures were rather narrow in focus, and therefore we are reserving judgment until we see what comprehensive actions are finally taken.

While our trade problems with Europe are probably less extensive, they may prove more difficult to deal with. Agriculture, steel, textiles, and export subsidies are areas of longstanding differences between ourselves and the community.

TRADE NEGOTIATIONS

The next 2 years will be a crucial time for the world trading system. We face a major challenge in facing serious deterioration in the world trading system, while at the same time obtaining fair access to foreign markets for U.S. exports.

In the next several months a series of meetings will help us to achieve our goals. The meeting of the GATT Ministers, the Ministerial Meeting of the GATT, November of this year is fundamentally important. It will provide us with an opportunity to solidify our efforts for free and more reciprocal trade.

Ministerial will help us focus full attention on the urgency of resolving the immediate problems facing us and of committing ourselves to addressing the longer term major trade issues of the 1980's like services and investment.

It's not intended to lead immediately to a major new round of multilateral trade negotiations in the near future. I'm not sure that any of the participants are ready for that yet.

But we do hope and I think have the right to insist on an international agreement on a work program on longer term trade issues during the Ministerial, as well as an international commitment to see that this program is carried out.

We will, likewise, be meeting with our major trade partners to review the implementation of the codes and the agreements which were established as a result of the Tokyo round.

FAIRNESS AND RECIPROCITY

These provide a major opportunity for reducing some of the most damaging nontariff restrictions against U.S. exports in areas such as product standards, customs valuation, subsidization, and product definition. These codes, however, are no more effective than the extent to which they are implemented.

The success of this evolutionary process will be a critical factor in determining the fairness of the trading system of the 1980's. So, we're going to be an active and aggressive participant in defending U.S. rights.

The administration will continue its strict enforcement of U.S. law and international agreements relating to international trade. Specifically, our antidumping, countervailing duty, and similar structures are designed to neutralize or eliminate trade-distortive practices which injure U.S. industry and agriculture.

We will continue to insist that our trading partners live up to the spirit and the letter of international trade agreements and that they recognize that trade is a two-way street. Accordingly, we will make full use of all available channels under the GATT for assuring compliance.

In addition to multilateral initiatives, we will continue to take up our trade grievances with individual countries in bilateral consultations. Through those consultations we will seek fully reciprocal market access, which is the best guarantee for the future of an open world trading system.

Some people have interpreted the recent emphasis on reciprocal market access a movement of the United States away from the open market system. Nothing could be further from the truth. Reciprocity for the United States means resisting entrenched and mounting protectionism abroad and nudging our trading partners forward to a level of market openness more similar to our own.

Improving U.S. economic performance and U.S. export competitiveness and access to foreign markets are top priorities of this administration, not restricting foreign imports.

Accordingly, exports need to become even more of a national priority than they are today. We have moved in a decade from 9 percent of our production of goods exported to 20 percent in the past year; $240 billion worth of goods were exported, and that figure will have to move even higher if we are to reduce the trade deficit which has exceeded $24 billion in each of the last 5 years.

In meeting this challenge, we not only promote our trading interests but make a solid contribution to the restoration of the health and vitality of our national economy.

This administration strongly stated its policy of free and open trade based on mutually acceptable trading relations and rules in its statement of U.S. trade policy, our white paper of last summer. I will reiterate that principle and policy today.

But we make no contribution to the achievement of this goal by ignoring attacks upon open trade by others. No nation can hope to sustain public support for a policy unless its people sense that there is equity for them in the application of that policy.

Thus, the 1980's will require the United States to pursue vigorously more equitable trade relations between nations. Such an effort, if undertaken with resolve and fortitude, can only strengthen our world trading structure in the GATT.

Of course, we need to insist upon full implementation of the Tokyo round, but we also need a renewed and revitalized trading system that is designed to deal with new barriers and problems as they arise through changing global economics and before they undermine past negotiating achievements.

During this past year, we have made a strong beginning toward such a goal, both domestically and internationally. As we respond to trade's message of change by adopting forward-looking economic policies, which also preserve and improve upon the system we have labored to create, I look forward to full and extensive cooperation with the members of this committee and with the Congress.

I thank you for your interest in the subject and the opportunity to be with you.

[The prepared statement of Ambassador Brock follows:]

Prepared Statement of Hon. William E. Brock III

I am pleased to have this opportunity to appear with Secretary of Commerce Malcolm Baldrige before the Committee at a time when U.S. trade policy is a topic of intense interest and scrutiny in the Congress, and a time of increasing concern about our trade outlook in the international arena.

On this my third appearance before this Committee, I would like to remind the members of my first statement presented to you one year ago. In my prepared text, I drew two conclusions from the international competitive situation in which we found ourselves:

"First, the United States must act quickly and decisively to reestablish a sound domestic economy in order to meet the competitive demands of the 1980's... in this regard, President Reagan's Program for Economic Recovery will make a substantial contribution toward reversing (our declining competitive position).

"Second, we must preserve and strengthen the open and fair trading system that we have been constructing for 35 years and on which much of our prosperity depends. The contribution of exports to domestic employment, agricultural production, corporate profits, and a strong currency require us to pursue further reciprocal trade liberalization. Protectionism can only hurt us ... it will damage market opportunities for our strong export sectors.... it will not provide...revitalization of our presently weak sectors."

One year later, these conclusions are no less true. With the passage of the President's Economic Recovery Program, our nation has taken a first major step toward strengthening its international competitive position. Incentives for increased investment in research and development can only help to make U.S. goods and services more attractive, in quality and price, to foreign markets.

Yet, the challenge before us of preserving and strengthening the open and free trading system is perhaps even more critical today. Many factors, both positive and negative, are weighing on the world trade system. On one hand, we are building momentum to tackle some of the most restrictive practices still affecting world trade, particularly in the areas of agriculture, services, and investment. On the other hand, the failure of past efforts to open some foreign markets is causing increasing frustration for U.S. exporters, in the Congress and in the Administration. The trade pressures currently being generated are more intense than at any time since the early 1970s.

<u>The causes of the sense of frustration in U.S. are real</u>. The United States has the most open market in the world. The opening of our market, however, has been predicated on the expectation that similar opportunities would be created for U.S. exports abroad. Our legitimate expectations, however, have not been fulfilled. Worse still, protectionism seems to actually be on the increase abroad.

With Japan we have an unequal trading relationship. U.S. producers who are competitive elsewhere around the world have made little headway in penetrating the Japanese market. The Japanese economy continues to expand. This expansion however is based on increasing Japanese exports while domestic demand and imports stagnate. Our deficit with Japan in 1981 exceeded $16 billion and may worsen this year. Japan on the other hand will run a surplus in its merchandise trade of about $21 billion in 1981 and as much as $35 billion in 1982. Additionally, the surplus in Japan's current account is expected to triple this year (from $5.5 billion in 1981 to $17 billion in 1982). The announcements of Minister Abe about the reduction of many import barriers is encouraging. However, these measures were rather narrow in focus and therefore, we are reserving judgment until we see what comprehensive actions are finally taken.

While our trade problems with Europe are probably less extensive, they may prove more difficult to deal with. Agriculture, steel, textiles and export subsidies are areas of longstanding differences between ourselves and the community.

<u>The next two years will be crucial for the world trading system</u>. We face a major challenge in preventing a serious deterioration of the world trading system while at the same time obtaining fair access to foreign markets for U.S. exporters.

What can we expect in the months ahead? On the agenda are a series of meetings which will help us meet our goals. <u>The meeting of GATT Ministers</u> in November of this year will provide us with an opportunity to solidify our efforts for freer and more fully reciprocal trade. The Ministerial will help us focus the full attention on the urgency of resolving the immediate problems facing us and of committing ourselves to addressing the longer term major trade issues of the 1980s, like services and investment.

The GATT Ministerial is not intended to lead to a major new round of multilateral trade negotiations in the near future. Neither the United States nor our major trading partners are ready yet for such an undertaking. However, we do hope to achieve international agreement on a work program on longer term trade issues during the Ministerial as well as international commitment to see that program carried out.

We will likewise be meeting with our major trade partners to review the implementation of the Codes and Agreements which were established as a result of the Tokyo Round. These provide a major opportunity for reducing some of the most damaging nontariff restrictions against U.S. exports in areas such as product standards, customs valuation, subsidization and product definition. These codes are, however, no more effective than the extent to which they are implemented.

The success of this evolutionary process will be a critical factor in determining the fairness of the trading system of the eighties. Therefore, in shaping the GATT's new code approach, the United States will be a most active participant and aggressive in defending its rights.

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The Administration will continue its strict enforcement of United States laws and international agreements relating to international trade. Specifically, our antidumping, countervailing duty, and similar structures are designed to neutralize or eliminate trade distortive practices which injure U.S. industry and agriculture.

We will continue to insist that our trading partners live up to the spirit and the letter of international trade agreements, and that they recognize that trade is a two-way street. Accordingly, we will make full use of all available channels under the GATT for assuring compliance.

In addition to multilateral initiatives, we will continue to take up our trade grievances with individual countries in bilateral consultations. Through such bilateral consultations we will seek the fully reciprocal market access which is the best guarantee for the future of the open world trading system.

Some people have interpreted the recent emphasis on reciprocal market access as a movement of the United States away from the open market system. Nothing could be farther from the truth. Reciprocity for the United States means resisting entrenched and mounting protectionism abroad and nudging our trading partners forward to a level of market openness more similar to our own. Improving U.S. economic performance and U.S. export competitiveness and access to foreign markets are top priorities in this Administration, not restricting foreign imports.

Accordingly, exports need to become even more of a national priority than they already are today. A decade ago only 9 percent of the total U.S. production of goods was exported. Last year over 20 percent, or over $240 billion worth of goods, was exported and that figure will have to move even higher if we are to reduce a trade deficit which has exceeded $24 billion in each one of the last 5 years. In meeting this challenge we not only promote our trading interests but make a solid contribution to the restoration of the health and vitality of our national economy.

This administration strongly stated its policy of free and open trade based on mutually acceptable trading relations and rules in its Statement on U.S. Trade Policy "white paper" last summer.

I reiterate that principle and policy today.

But we make no contribution to the achievement of this goal by ignoring attacks upon open trade by others. No nation can hope to sustain public support for a policy unless its people sense that there is equity for them in the application of that policy. Thus, the 1980's will require the United States to pursue vigorously more equitable trade relations between nations. Such an effort, if undertaken with resolve and solicitude, can only strengthen our world trading structure and the GATT.

Of course we need to insist upon full implementation of the Tokyo Round, but we also need a renewed and revitalized trading system that is designed to deal with new barriers and problems as they arise through changing global economies and before they undermine past negotiating achievements.

During this past year, we have made a strong beginning toward such a goal, both domestically and internationally. As we respond to trade's message of change by adopting forward-looking economic policies, which also preserve and improve upon the system we have labored to create, I look forward to cooperating with the members of this committee.

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SOVIET GRAIN SALES

Representative RICHMOND. Thank you, Ambassador Brock.

Senator Jepsen, who had to leave for a vote on the floor and another meeting, asked me to ask Secretary Baldrige——

Secretary Baldrige, in your statement, you say this administration has made clear from the beginning that our approach to trade with the Soviet Union must be consistent with our political and security objectives.

Senator Jepsen wants to know whether you call paying off the interest due in the Polish debts consistent with terminating negotiations for grain sales.

Secretary BALDRIGE. If I understood the question—paying off the Polish debt consistent with what?

Representative RICHMOND. Senator Jepsen, I believe, is very, very anxious to make known his position that he would be dead against any termination of the sales of American grain to the Soviet Union and its satellites.

And he wonders how you reconcile our wanting to apply sanctions in the Polish situation on the one hand, while we have just paid off the interest bills, to the tune of some $80-odd million, correct?

Secretary BALDRIGE. Yes.

Representative RICHMOND. Senator Jepsen is particularly interested in what you plan to do about negotiations of grain sales.

Secretary BALDRIGE. Well, in the first place, we looked on that, the CCC payments to the bank were actually transferring that debt from the banks to the U.S. Government. It's still owed by Poland. That's the first point. The second point is that those were guarantees to the banks by the Federal Government, so it was proper to do so. The third is that we feel it's a stronger action, at this time at least, not to call Poland into default because we have more leverage over what happens there in the future if we keep this present stand we have. It is reviewable every 3 months or less, but it gives us more freedom and leverage with the Poles and the Russians than a simple default would.

Now, the other part of this question on the agricultural or potential grain embargo, the President has not decided to do that yet. That does not mean he will not in the future. I can't comment here on whether if he did so decide, whether it would be in the context of a complete embargo or not, but it is fruitless to speculate on that right now because he has not decided to do that. That's not our present policy.

Ambassador BROCK. I can add one thought, Mr. Chairman. I think the President made himself abundantly clear in 1980 on the subject of a selective embargo in which he stated his opposition to the limitation on one particular sector of the U.S. economy, to wit, the farm sector, he suggested we should not ask them to carry the entire burden of the U.S. foreign policy. I think that that statement, while it was somewhat controversial during the campaign, was in fact endorsed by the U.S. Congress in the Farm bill, when you passed an amendment offered by Senator Jepsen suggesting that selective embargoes were not a policy of the Congress either, and that if any administration in the future were to impose an embargo on farm goods without imposing an across-the-board embargo under a national emergency determination, that in fact the parity payments would go to 100 percent automatically and that would cost $30 billion, and that's a rather stiff price to impose on the taxpayers, and I think any administration would be somewhat cautious about such embargoes in the future.

PROBLEM OF TRADE RELATIONS WITH JAPAN

Representative RICHMOND. Thank you, Ambassador Brock and Secretary Baldrige.

Would you agree that probably our biggest problem in international trade today is our relations with Japan? By and large, from my own study of other trade relations, it appears that they are coming along rather well. We are not getting equal treatment from the Japanese and I don't see any other area where we're really being discriminated against; am I right?

Ambassador BROCK. We have rather severe problems with Europe, Congressman. And as I said in my statement, they may be even more intractable because both sides honestly believe that they are in the right and within the confines of international agreements.

Representative RICHMOND. Do you think the Japanese honestly believe that they are in the right?

Ambassador BROCK. No; but I think the possibility exists for resolution of the problem with regard to Japan in a more expeditious fashion.

Representative RICHMOND. Ambassador, you're doing an absolutely herculean job. You finally got them to give in on 67 out of 99 miscellaneous items. Now, that sounds great, 67 out of 99. It sounds marvelous, until you get to the bottom line. If you took all 67, and didn't assume that the Japanese were going to get around us through further regulations and God knows what, which they always do, the maximum trade involved in those 67 items would be $200 million. And you just said in your prepared statement that our deficit with Japan this year could be $35 billion? When are we Americans——

Ambassador BROCK. That's the overall trade surplus that Japan could have, but not with the United States. That's overall.

Representative RICHMOND. Well, the United States can be, what? $25 billion?

Ambassador BROCK. It could approach $25 billion.

Representative RICHMOND. With them only spending 0.9 of 1 percent of their gross national product on national defense and letting us do their defense job, and letting us do all their basic research to boot.

Ambassador BROCK. I do not mean to understate the problem, but I think if you're going to deal with the problem you have to keep it in the context of what is, in fact, happening. Prime Minister Suzuki, in December, made an important statement and that is that the Japanese Government was being directed to come to grips with this problem. They have moved their tariff schedule ahead by 2 years. They have announced a series of answers on nontariff barriers, as you mentioned, 67 out of 99. Some of those were duplicative, some of those are not particularly relevant, some of them we didn't even think were the right thing to do. But the fact is that they have taken steps, and we believe that if the relationship is going to continue, this must be one of a series of continuing steps. I am encouraged that that is, in fact, the case, that we do have more to hope for.

Representative RICHMOND. I just want to know when we're going to get into big dollars and get out of little ones. There are so many items of American manufacture and American production that the Japanese people, the Japanese consumer would love to have. Take American cigarettes. We know for a fact, from any number of surveys we've done in Japan, that 40 percent of all Japanese cigarette smokers would prefer to smoke American cigarettes, even though they cost three times as much as Japanese cigarettes. Right now in Japan, Japanese cigarettes made out of one-third American tobacco cost roughly 40 cents a package. They charge for American cigarettes $1.25 a package. Yet, the Japanese would prefer American cigarettes if they could get their hands on them. But of their total, what, 250,000 cigarette outlets they only allow our cigarettes to be sold at 25,000 outlets.

Here's one item—and I don't smoke, but if the Japanese want to smoke, I think it's fine. Here's one item alone that could come to several billion dollars of trade, where we can supply the Japanese market a lot cheaper than they can themselves, with a better quality cigarette, a cigarette the Japanese people want. yet, the Japanese Government makes sure that we're not allowed to ship our cigarettes in.

Ambassador BROCK. Please don't put me in the position of defending Japan, Congressman. I have no desire to do that.

Representative RICHMOND. I just wanted to tell you how much I sympathize with you and how I wish you had just a little more—a few more weapons at your hand to negotiate somewhat.

PROGRESS BEING MADE WITH JAPAN

Ambassador BROCK. We may get some of those weapons and we are not lacking in some now, and we have made progress. All I am suggesting to you is I think the prospects for change are very real, and if we stay on course, if we continue to exercise our maximum leverage in active work and if we have the support of the leadership of that government, Minister Abe, the Foreign Minister, I think we can make a difference and make it in the next several months. I hope so.

Secretary BALDRIGE. Congressman, may I just review the last year, because I think this helps to put it in the proper framework. A year ago there was no way that the Japanese Government was inclined to talk much about open markets. You could talk about a single case here, a single case there, negotiate for a while and so forth. Since then, last fall, after the administration had gotten its position together, some five Cabinet officers have been to Japan carrying exactly the same message, among them Ambassador Brock and myself. You now see this year, a year later, the Prime Minister of Japan and many of his cabinet officers that have anything to do with economics or trade, publicly calling for the need for Japan to open their markets.

Now, the 67 points came out of that initiative. We are disappointed in the 67 points. Let me be specific, 19 of those 67 points had already been acted on. Another nine were requests by Europeans or third world countries. Six of them were individual, not generic cases, so they just applied to one product. Five of the cases were counted more than once, and 5 were possible future actions; so if you took 44, which that adds up to, that leaves 23.

Now, of the 23, many of those measures approved by the Government of Japan, which are of real potential benefit, we have to discount rather heavily because the more traditionally conservative administering agencies in Japan are still given a lot of leeway in how those are applied. So we have to discount that.

Also, we were disappointed because the areas where the United States could make immediate and substantial gains, you mentioned tobacco, the quotas on beef, citrus, leather, controls on cigarettes, cartel arrangements on soda ash, those are immediate and quite sizable numbers. If those markets were open to us and it was a completely free competition, you are not talking about $200 or $300 million. You're talking about—I don't have the exact figures here.

Representative RICHMOND. $20 billion, Mr. Secretary.

Secretary BALDRIGE. It would be over a billion.

Representative RICHMOND. $20 billion.

Secretary BALDRIGE. I'm talking about just those areas, now, the ones I just mentioned. Then we could go on from there.

This opening of the markets is not enough to close anywhere near the entire trade deficit. That isn't the point. The point is to make enough of a dent in that so that we can continue to expand both our two-way trade, recognizing the salient fact that Japan must recognize, that they are the second largest Western industrial economic power in the world today, and as the second largest power, they have to face up to the responsibilities to open their market to accept more imports, if they want to export more. I think that's clear.

Representative RICHMOND. Mr. Secretary, I am told on good authority, that here's a country half our size in population, the size of the State of Montana geographically, that will exceed us, next year, in industrial production so they will be the No. 1 industrial producer of the world. And we foolish Americans will be sitting back buying their luxury goods and allowing ourselves to be financially raped and doing nothing about it. What right do the Japanese have to ship Japanese cars to the United States which sell at the same price as they do in Tokyo, and charge 300 percent extra taxes and duties on American cigarettes in Japan? It's totally unreasonable and improper.

FAIR TRADE WITH JAPAN ACT

I know you and Ambassador Brock and Under Secretary Olmer are doing the best you can, but you're working against terrible odds. As a result of this, I have a piece of legislation which I hope will be acceptable to the administration. It gives the President the right to demand that Japan ship us only half as much in luxury, heavily manufactured goods as we ship them in basic commodities. As you know, Canada and Australia, tradewise, are much smarter than we are. They have positive balances of trade with Japan because for every dollar's worth of commodities Canada and Australia ship Japan, they only buy back 50 percent worth of relatively unnecessary luxury goods.

The bill I have that's in the drafting stage now gives our President the same authority to invoke in dealing with the Japanese. I think it's about time we really let the Japanese know that we are badly off and they are far too well off for their own good. They don't have any unemployment. They could lower the prices of food for their consumers from 25 percent of their consumers' income to 18 or 16 percent, if they would trade more with us. Just because of this little handful of farmers in the rural areas of Japan which controls the Liberal Democratic Party, the Japanese consumer who, as you know, lives in that great corridor between Tokyo and Osaka is paying two, three, four times too much for his food.

BENEFITS TO U.S. ECONOMY

Now, when are we going to talk real hard turkey with the Japanese and say this sort of nonsense has to stop? We can't afford it. There are 500,000 American jobs that would be created—can you imagine that—if the Japanese would treat us fairly. I have no objection to the buying of Japanese cars if American people think they are better than American cars. I personally don't think Japanese cars are better, but some people do. We're a free country. If somebody wants to buy a Toyota, it's their business. I won't have one.

On the other hand, if the Japanese would just buy those products that we have that are clearly better than theirs, cheaper than theirs, more nutritious than theirs, more efficiently produced than theirs, this would make 500,000 American jobs. That would save the U.S. Government $12.5 billion. That's the figure. Every million unemployed persons costs our Government $25 billion. We could put people back to work. We could start processing much of our material that we're now shipping raw.

Then, the Japanese consumer would find his food bill in many, many cases would go down by 50 percent. Instead of paying $15 a pound for beef he could buy it for $3. We could sell him his rice at half the price he's paying. We could sell him his dairy products for half the price. We could sell him his cigarettes for a third of the price. Why don't we demand equal treatment once and for all?

Ambassador BROCK. Congressman Richmond, you are preaching to the choir today, you know. [Laughter.]

Representative RICHMOND. But somehow or another I have to give you some ammunition so that you can go over there and demand these things, because so far, they are just not taking you seriously.

Ambassador BROCK. I want you to understand that I'm not sure we lack ammunition. We've got a lot and it has been used, and there have been some very, very frank conversations. There's nothing that's been said in this room today or in the last 12 months that hasn't been said in one-on-one conversations with a number of different Japanese leaders, from the Prime Minister down. I believe that we can make a difference.

I believe we are going to make a difference. I believe it is imperative that we make a difference. Let me raise one cautionary note, though. This Nation has, for 50 years now, since 1923, adhered to a principle established by law called "most favored nations." We have consciously fought against selective application of U.S. trade laws to any other single country, but rather have sought to deal with the strengthening of international systems, the GATT to provide for reciprocity in a legitimate legal form. That commitment is absolute today. It is maintained, and it would be, I think. extremely hazardous for the world system and for the well-being in the United States, for us to act by statute in a fashion that was not compatible with our legal agreement on with the GATT. And I think any action against a particular country enforced by legislation which required us to violate those agreements, would be not only detrimental to the United States, but to all that we believe in, in the development of a liberal world trading system.

Representative RICHMOND. Except, Mr. Ambassador, never before in these 50 years have we Americans seen ourselves living in the "colony of the United States". The Japanese are very effectively using us as a colony, and I object to it.

Ambassador BROCK. Congressman, we're not that bad off.

Representative RICHMOND. Mr. Ambassador, I think we're so badly off I can't recall when we've been worse off, and I think if we could at least get equity from the Japanese, it would help our national deficit to the tune of $20 to $30 billion, which I think would be a wonderful thing to happen.

Ambassador BROCK. I'm absolutely confident that we're going to get equity from the Japanese, because I don't think they can survive without us. And it isn't a matter of being presumptuous.

Representative RICHMOND. There's no question it is not.

Ambassador BROCK. I think we need each other badly, and I think they understand that.

Representative RICHMOND. Mr. Ambassador, they need us a lot more than we need them. Right now we're shipping them corn at $2.50 a bushel, which if you index that back to the Great Depression, would be $0.36 a bushel. During the Great Depression, corn was selling at $0.48 a bushel. So our American farmers today are getting less per bushel of corn from Japan than they were selling their corn at during the Great Depression. Soybeans the same thing.

Ambassador BROCK. We're not getting any less from Japan than we are from other countries. Let's look at the fundamental part of the problem.

Representative RICHMOND. I don't want to ship them corn.

Ambassador BROCK. When we started putting on selected farm embargoes, going back to our own administration in the early 1970's on soybeans, when a Republican administration made the mistake of putting an embargo on soybeans, because prices were too high in this country, and all of a sudden, we broke the faith of the Japanese market in the United States as a reliable supplier, and they started planting soybeans in Brazil. Now unless this Government starts acting consistently for a change, it's hard for our trading partners to know where we're coming from next.

JAPANESE PROGRESS ON TRADE LIBERALIZATION

Secretary BALDRIGE. Congressman, can I add another word about what Ambassador Brock and I think is going on in a very practical sense and why we are against individual selective embargoes or tariffs? There is major change in the policy of the Japanese Government. It did not come easily for them. That change has truly been accomplished. That's the difference between this year and last year. Now we want to see the results of that change. Both Ambassador Brock and I think that when we testify here a year from now, that we will have seen the practical results of this change, because we have seen the first step, although we have described it as a disappointing step, we have seen the will behind that step of the Japanese Government to make a change. That will has to be translated into a consenus that they must achieve politically, and they are in the process of doing that now.

Part of these barriers are not even—you wouldn't even describe them as nontariff barriers. They are cartel industry associations who literally believe—I'm not sure "patriotic" is the right word, but it's for the good of them all to "buy Japanese," in quotation marks. All of that has to be changed as part of an overall approach to get at this problem. If we try and go at them one by one with a sanction here and a sanction there, we could be negotiating until the year 2000 and still not get at them all. The list of potential trade barriers you could paper this wall with. This has got to come from the Japanese Government, getting their industry with them and their people understanding why they are doing it.

And I've got to say on behalf of the Japanese, that is not an easy task. After all of the years in recovery from World War II and looking on themselves as a poor, small, struggling island economy, now they're the second largest industrial economy in the world, and the Japanese man in the street doesn't really understand it that way. So that's a difficult thing to change. We think that is definitely going to change more this year, and we're headed in the right direction, but I don't think selective controls are going to do anything to aid that problem.

OVERVALUED DOLLAR

Representative RICHMOND. Let me ask you one last question. My time is up. I think it's both for Ambassador Brock and the Secretary. Our dollar presently is terribly overvalued due to high interest rates. I assume that is having a very detrimental effect on our international trade. Can you quantify that at all and tell us how many more billions of dollars in trade could we have if our dollar weren't so totally overvalued?

Ambassador BROCK. I'm not sure it's possible to quantify that precisely. Maybe Mac could do better than I, but I think what's happened—in all honesty, we have done remarkably well with the dollar going up as fast as it did in a short period of time. It's gone up relative to some currencies as much as 30 to 35 percent. Currently, it's up 15 percent. The point is, we are competitively disadvantaged by a dollar that is strong and a yen that is, I think, unnecessarily weak, and that's a matter of Government policy perhaps.

Now it is true that we have held our exports on sort of a plateau. We haven't had the increase, but our imports have absolutely surged as a consequence of the shift in the valuation. I do think one of the steps that could be taken would be some steps in Japan to strengthen the yen, because I honestly believe it is substantially undervalued, perhaps as much as 15 to 20 percent. That would mean a great deal to us in trade terms, and very quickly so.

Secretary BALDRIGE. But we should hasten to add, Congressman, that when there wasn't this difference that there is now with the dollar strength of the yen, when the dollar was relatively weaker to the yen, we still had a 25-percent increase in the deficit in those years, as a fairly standard thing. So that is part of the answer. That's a part of the answer that the Japanese will throw at us. They have several things they'd say. One, "Well, you fellows aren't productive enough, and the American businessmen don't come over and work hard enough at it." And just let me take that point——

Representative RICHMOND. Ambassador Brock said that he thinks the Japanese yen is unfairly low, and we know that the Japanese Government controls their interest rates and keeps those interest rates very, very low.

Secretary BALDRIGE. But I do not think that that would solve the whole problem. It's a point, but that's not going to solve our problem. Their opinion that they throw at us, that we should be more productive, our businessmen ought to work harder over there, and we could crack that market, is just dead wrong. In the middle section, let's say if you took high technology, medium technology, and low technology, semiraw materials, they are excellent in the middle ground. Automobiles, TV's, radios, and so forth. In high technology we are ahead. In the semiraw material area, soda ash, things like that, we're ahead.

We can't get into their markets there, that's our problem. They can come over here. So, I reject that argument. As a matter of fact, it makes my hair stand on end when I hear that you Americans ought to work harder in getting in those markets. I know a lot of American businessmen who work like hell at trying to get into those markets, and there are too many barriers against their being able to do it. That's not the answer. The value of the yen isn't the answer. The answer is opening up those markets to us and let free competition take hold.

Representative RICHMOND. Thank you. Mr. Chairman.

HIGH INTEREST RATES, OVERVALUED DOLLAR, AND DECLINING EXPORTS

Representative REUSS. Thank you, Congressman Richmond.

Ambassador Brock, you referred in the first page of your proposed statement to what you said a year ago, and you quote what you said. First you say that "the United States must act quickly and decisively to reestablish a sound economy. In this regard, President Reagan's program for economic recovery will make a substantial contribution toward reversing our declining competitive position." Whatever it's ultimate virtues may be, isn't it a fact that the economic recovery program has, in fact—through a policy of monetary restraint and through the prospect of future deficits—resulted in an extremely high level of American interest rates, and hasn't this resulted in an extremely overvalued dollar, and hasn't this resulted, particularly in recent months, in a very alarming decline in American export orders and a deterioration of our competitive position?

Ambassador BROCK. No, sir, that is not correct.

Representative REUSS. Why am I in error? [Laughter.]

Ambassador BROCK. We had this discussion before, I'm sure. The economic program that we proposed was for a tax reduction earlier in the year and of larger consequence, to restore our incentive for saving and for investment and for work. The Congress made its own adjustments, which it has every right to do in that program, but I do not think it is equitable then to say that the economic program has not worked as intended. It isn't in place as originally designed and won't be now until July of this year, when the second stage tax cut takes effect.

Representative REUSS. We do now have, I'm sure we all agree, exorbitantly high interest rates and we'd like to get them down.

Ambassador BROCK. Absolutely.

Representative REUSS. Our very high structure of interest rates is in considerable part reflected in the inordinately high exchange position of the U.S. dollar, not only vis-a-vis the yen but vis-a-vis the deutsche mark, the Swiss and French francs, the lira, and almost every other currency; is that not so?

Ambassador BROCK. I expect that is part of the problem.

Representative REUSS. Yes. There are other factors, but I think that's an important one. And isn't it also a fact that in the past few months export orders of major U.S. firms for sales of goods abroad have declined very sharply?

Ambassador BROCK. In certain areas, they have.

Representative REUSS. Well, aren't those certain areas of goods decline practically the entire spectrum, leave aside agricultural?

Ambassador BROCK. I don't think you can go that far.

Representative REUSS. Don't just take engineering products, those things that are made in factories.

Perhaps Secretary Baldrige would like to answer.

Secretary BALDRIGE. Yes, there's been a slowing down in our export rise. That's still a problem, but, Mr. Chairman, consider the alternatives. In 1980, we had inflation touch 18 percent for awhile. It averaged almost 13 percent for the year, 12.6, I think, 12.4, 12.6 percent. The inflation problem in the last 10 years has started to drive our cost structure up, made us less competitive, has hurt us much worse on the international trading market than any possible strengthening of the dollar we have seen. And how do you get inflation down without some of the difficult measures we're taking? We're going through some of the withdrawal symptoms now. But if we want to be truly competitive, we have got to whip inflation, and that's a much bigger curse on our efforts in international trade than a strong dollar is now.

Representative REUSS. Your position, Mr. Secretary, is entirely consistent with the economic report of the President, which came out——

Secretary BALDRIGE. I thought that before I came down here to Washington, Mr. Chairman.

Representative REUSS [continuing]. At noon today.

Ambassador BROCK. I would hope so, otherwise we're in trouble.

Representative REUSS. And it is said there, and I'm quoting from page 47 of the report, "The decision to end inflation over a period of several years will be sustained by this administration, even though short-run costs will be suffered before long-term benefits begin to accrue."

I think that's saying about the same thing that you just said.

Secretary BALDRIGE. We don't see an easy way out, no. I don't know anybody that has one.

Representative REUSS. My question is simple. Maybe there is no easy way out, but isn't one of the victims of this policy that segment of American industry which makes goods for export?

Secretary BALDRIGE. No, I don't think so at all. I think there would have been much worse victims if inflation would have been allowed to keep on. We just have to look right down at our southern neigobors, Mexico. They have—I don't know what the exact figure is now—somewhere around 25- to 30-percent inflation, and their interest rates are 40 percent. If you're a small businessman trying to start up or even a large businessman, you've got to pay 40 percent for your money. How are you going to hire enough people and be competitive in the international export field, looking at figures like that?

MONETARY POLICY AND INTEREST RATES

Ambassador BROCK. Mr. Chairman, you know, implicit in your question is the suggestion that the monetary policy has caused the interest rate problem. I don't think anybody I know of can really accept that when interest rates are predicated upon an inflation base, as they invariably are and always have been and will be.

Representative REUSS. If that is so, Bill, how come we have got 8-percent inflation and a 16-percent prime rate?

Ambassador BROCK. If that's so, then why don't we ask the other question; Why didn't interest rates come down when the Federal Reserve lost a little bit of control in December and the money supply went up at an exorbitant rate of 14 percent? In your normal theory that increase of supply would have pushed down the price of money, but it didn't, it increased the price of money. The bond market went down, the prices went back up again.

Representative REUSS. Let me just take off from that. It is true that in the last month or two of 1982 and in January, M1 increased at, I think, 13 percent. That was not good, was it? You didn't like that?

Ambassador BROCK. No.

Representative REUSS. I now turn to my other friend, Secretary Baldrige, and ask him about the following. I mentioned this beforehand. While Bill Brock and President Reagan were deploring the 13-percent increase in M1, isn't it a fact that the Department of Commerce was issuing its leading indicators and proclaiming to the world that the leading indicators showed improvement, and guess what the leading leading indicator was? The 13-percent increase in

M1. I think we either should call these "misleading indicators" or purge out of it that M1 thing. I think we don't want a leading indicator which causes our friend, Bill Brock, to have fits, but which is proclaimed as something good.

Secretary BALDRIGE. Mr. Chairman, I think you've got a point there, but I don't think it's the leading indicator. There are some 10 leading indicators. That's one of the 10. The fact that the housing industry was picking up and some of the others had as much or more impact, it is a fact that the increase in the money supply is one of the leading indicators, and it's probably a fact that that was a good leading indicator in days when the money rise was a little—you know, was not as—perhaps as erratic.

Representative REUSS. It was constructed back in the 1930's and 1940's, I believe.

Secretary BALDRIGE. So I take your point that it ought to be reviewed. The leading indicators are not infallible, but they have had a pretty good and consistent record of success, if their trend, for whatever reason, has kept in the same direction for 4 or 5 months. The leading indicators began improving in Sepetember, I think it was minus 2.1 and then minus 1.6, then minus 2 or minus 0.6 and plus 0.2. Now those are not dramatic changes, but the change has been there for 4 months, and usually 4, 5 months after that kind of a trend, you begin to see a recovery. As I say, they are not infallible, so we can't use that as a——

Representative REUSS. The mere fact that the other nine may be not misleading, doesn't, it seems to me, justify the inclusion of one that I believe is. Well, we can't settle it here.

Secretary BALDRIGE. I will take a look at it. You do have a point there.

Representative REUSS. Would you? Because I think we would be better off if we dropped that indicator. There are some 300 indicators on the cutting room floor of your Department, 10 have been selected. My point is, nine would be enough.

LONG-TERM CAPITAL MARKETS AND INTEREST RATE VOLATILITY

Ambassador BROCK. May I just have a moment to go to the larger question, though, and express a pet peeve with these numbers as they come out, Mr. Chairman? We did design these economic bases back 30, 40, and 50 years ago, in some cases. Today the long-term capital markets of the United States have suffered for several years now just an incredible assault upon their continued viability. When interest rates go to 21 percent, back to 10, back to 21, down to 13, back to 15 or 16, what you are fundamentally doing is attacking the psychology of a long-term placement of funds in a fixed investment. And at the same time that you do that, we've got people so sensitive to the money market indicator that they make market judgments, investment decisions, on a weekly disclosure of the Federal Reserve System of money market numbers.

Now Mr. Chairman, that is a terrible way to make a decision on a 30-year investment on 1-week release of a monetary figure. Wouldn't it make more sense to stop coming out with all of these things on a weekly basis and do a rolling average or at least try to treat the thing in a broader and longer term perspective? But I don't see—I think your point is valid, in terms of the indicators, simply because the market is reading weekly releases rather than judging fundamental economic performance in its projection 20 to 30 years out. And I think that's a valid point.

Representative REUSS. Do I gather then, that you break with the Federal Reserve and with Milton Friedman in their monetarist approach, which says that we aren't going to look at interest rates, we're just going to look at the monetary aggregates? Good men have.

Ambassador BROCK. I don't see how you can do either to the exclusion of the other, to be honest with you. I think you have to have a more balanced approach.

Representative REUSS. Excellent. I agree. Well said. My time is up.

Representative RICHMOND. Senator Roth.

Senator ROTH. Congressman Richmond, I apologize for being late. I do have an opening statement, which I would ask to be included in the record.

Representative RICHMOND. Without objection, Senator; and I have also included Senator James Abdnor's opening statement.

RECIPROCITY LEGISLATION

Senator ROTH. I would like to welcome both the Secretary and Bill Brock here today. And I would like to recapitulate what I was going to say in my opening statement and then ask you a question.

I would like to focus, if I could, just a few minutes on this question of reciprocity. I think both of you gentlemen know that I have been a longtime strong supporter of free trade and measures to promote it. I think it can be said, in all fairness, that the U.S. market is the most open market in the world, at least of any major market. The same, frankly, can't be said elsewhere. Bill, you were on the Finance Committee when we were actively involved in adopting the legislation that led to the last round of trade talks. I enthusiastically supported those talks and multilateral agreements. Once again, we were taking a major step toward opening markets. What has concerned me, however, is that others have failed to follow our lead.

For years, our international trading system has been based on the principle that no country should be accorded less favorable treatment than that given our most favored trading partner. While I've been a strong supporter of that most-favored-nation-principle, I find that with each round of negotiations, the MFN treatment accorded by the United States is far more favorable than that granted by our trading partners. Moreover, I think our friends around the world do not take us seriously. While I believe strongly in free trade, it seems to me that we have to take some steps and measures to insure that markets in other countries are just as open as our own. That is what I understand to be the purpose of reciprocity.

Is there any reason why any country should fear reciprocity if their own market is open?

Ambassador BROCK. Not at all.

Senator ROTH. Is there any reason any country should expect to have the right to move openly into our market to bring their insurance companies, their banks, or open department stores in the United States, if we cannot do the same? What's unfair about our asking the same rights? It seems to me that, if properly used, reciprocity is a weapon for free trade. It all depends upon the objective or goals. But in espousing or talking about reciprocity, aren't we talking about using the incentives of our market to get other countries to do the same, so that we have the same open market opportunities overseas?

DEVELOPING COUNTRIES PROGRAM

Ambassador BROCK. Precisely. If you would permit me, maybe I could elaborate just a little bit on my own view of this particular subject, Senator, because it is an absolutely crucial subject and will be for sometime now. I don't think that there is anything that you have suggested that is unfair or unwise. I would like to make two distinctions, though, as we approach the subject. One is that we have a distinction between countries, and that is between the fully competitive industrialized countries and those newly developed or newly arrived. I think that is not only a wise, but an ethical and moral thing to do. We have given preferential treatment to the developing countries. We give them special access to our markets under the GSP program. We have been very forthcoming, more than any country, in trying to take steps to help those less fortunate than ourselves to have an opportunity for economic growth and job creation by providing access to the U.S. marketplace.

GATT

So I think I would like to draw that distinction first. When we're talking about reciprocity, we're talking about reciprocity among equals, not as a device to impose some new barriers to those who have no other opportunity. Second, we have reciprocity available to us in the goods area under the GATT. The whole purpose of the international trading system, which to date, has been limited to a trade in goods, was to devise a method of achieving equity among equals, to provide a two-way street, if you will, and if there are disputes among us, to provide a mechanism for the legitimate and predictable and equitable resolution of those disputes.

Now when Japan engages in a quota against beef, citrus, leather, cigarettes, or whatever, they are acting in contravention of those agreements, and we have a legitimate place to go to address the problem.

So I would be particularly concerned if the use of the word reciprocity were to become perverted into an attack upon the GATT and become, then, a device for bilateral treatment of our trading problems. I don't think we ought to do that, become a device or euphemism for protectionism. Where I think it has particular applications is the kinds of things that you mentioned: Banks; insurance companies; financial institutions; capital flows; all of those things, which, in fact, provide the ingredients for all trade. I don't see how you can even talk about trade in goods, unless you have trade in services or investments, and one of the fundamental inequities in our relationship with Japan, as an example, and there are other countries. We shouldn't single them out, but they are the largest problem, and that's what the chairman has said—is that we have no access whatsoever to the capital markets, to the investment opportunities, to the services trades of that country. And in that sense, reciprocity is something we have every right to seek and to insist upon.

Senator ROTH. Well, I see reciprocity as a weapon to open up markets, not close them.

Ambassador BROCK. Absolutely.

Senator ROTH. And I think that's the point that you and many of us are trying to make.

I'll be candid, I think a lot of people look on the United States as "Uncle Sucker," that our markets have been open, and they don't really have to worry about it, fair trade practices, since we will talk and we will complain, and a lot of smoke will be burned around the Capitol, but nothing will happen. It seems to me through reciprocity we are really adding a new dimension to try to achieve the purpose of GATT. I agree with you on your comment that it is right and proper to help underdeveloped countries with preferential treatment.

I hope we will look at this whole concept of "most favored nation," to determine how well it is working for us and for an open market system throughout the world.

TRADE ADJUSTMENT ASSISTANCE

I have one other question. One of my concerns is that, in order to get support here at home for trade and exports we have to make certain that those who are adversely affected—and some will be and are being adversely affected—have some kind of a policy to protect them. They do not have this protection under this administration. The dismantling of the trade adjustment assistance program did not start this year or last, however. It started in the Carter administration.

My question is, How can we expect the working people who are adversely affected, to be supportive of a free trade policy, if we don't have some kind of program that protects those who do suffer because of a national policy?

Secretary BALDRIGE. Well, as you know, we do have trade adjustment assistance. But I can't describe that program as a howling success, as much as I would like to, Senator. When we came here we had what I believe was the first audit of loans in our Economic Development Administration, and I found it hard to believe the audit which was done by our own people, so we hired an outside firm to check up and we found in the actual trade adjustment assistance loans, that 33 percent of them were in default. The EDA loans were up to 40 percent. Now, it becomes a question of how much good you are doing when you come up with figures like that.

It's a very tough thing for an old industry, noncompetitive any more for whatever reason, to face up to the realities of trade and you can go two ways. You can either give them money to keep them alive, which in most cases just gets them further and further behind as time goes on, or as happens in so many cases, the management has to adjust, do something, face up to the problem.

Our industrial evolution has been a history of that. We see terrible troubles in trade now with some of the European communities because they have tried to keep older plants alive with subsidies. We have run into them exporting them to us. We have to countervail or use antidumping. That's a very serious deterrent to free trade, any kind of a subsidy program. I would be all for the trade adjustment assistance increasing that, if it had a record of success, but that's not a good record.

Senator ROTH. My time is up. The only closing comment I would make, undoubtedly there are many weaknesses in what has been done in the Trade Adjustment Assistance Program, but I think this is something that we ought to put some of our best thinkers on if we want the support of the public at large.

Ambassador BROCK. I agree, and if I could just add one thought, I think the Secretary and I approach this almost identically from the same point of view. When we had a program, it didn't work and it was abused. Now we have tried to retrench substantially, but if there is an answer it almost has to come in the area of training, providing people with new skills because jobs always will change in a dynamic society.

Senator ROTH. That's what the Japanese have done.

Ambassador BROCK. The one thing we don't want to do in America is to freeze everybody in the same occupation. That would be a desperate mistake to do. And the one thing we can accept as a governmental responsibility is a better and more coherent effort in the training efforts that we have.

Senator ROTH. Thank you, Representative Richmond.

Representative RICHMOND. Thank you, Senator Roth.

Congresswoman Heckler, our witnesses will be here for another 10 minutes and it's your time.

Representative HECKLER. Thank you very much. I want to welcome our witnesses and apologize that another committee meeting kept me from being here to hear your testimony, but I have reviewed it.

TRADE BARRIERS WITH JAPAN

Secretary Baldrige, last year our trade deficit with Japan was $18 billion. Recently Japan published a list of 67 measures it plans to take, to make access easier to that country's market. These measures, which deal largely with restrictive standards and inspection requirements and burdensome custom procedures, fall short of the U.S. list of requests for trade liberalization. An article in the Wall Street Journal recently stated that even if Japan were to do all the United States is asking, the actions would only reduce $800 million from the bilateral trade deficit.

My question is, Do you agree with the Wall Street Journal's assessment of what elimination of the formal trade barriers would mean for United States-Japan trade? If not, what should we do? How do we go beyond it? How do we affect this meaningful change that you and your predecessors have expressed such concern about?

Secretary BALDRIGE. Well, honestly, I don't always disagree with the Wall Street Journal, but I have twice in the last week, and that's one of them; $800 million is not the right figure to use for an estimate there. If you took beef, citrus, and tobacco—by tobacco I mean cigarettes, because they buy a lot of tobacco from us but they want to be the only ones that make up the tobacco into cigarettes, if you just took those three items you are talking—and you have to estimate market share and so forth. But to be very conservative, you are talking about probably close to $2 billion just in those three areas.

JAPANESE INDUSTRIAL POLICY

Now, the other areas, you know, besides just those three of course would be above and beyond that figure. I would add, though, that the openness of the Japanese markets is perhaps half of the problem. The other half of the problem that we haven't addressed here today, but I do think is tremendously important to mention it, is the way in which the Japanese Government and their industry target certain areas for takeover, certain of our markets for takeover, world markets, but they happen to be ones that we are very strong in.

In the semiconductor field they are the building blocks of the whole high-technology industry. The Japanese decided to do that some years ago; clearly, we feel, used government subsidies to get this start; are now in the process of expanding as a result, so that they can come over and literally take over our market. We do not subsidize in any way, shape, or form. It's worth it to them to probably lose money in that effort until they have market control, and then they are able to compete more succesfully around the rest of the world.

Now, that kind of consensus, building that kind of use of subsidies, that kind of targeting on areas that are agreed on by all, is the kind of competition that is most difficult for us to beat because we don't have those kinds of subsidies in the United States. That's the other part of the problem. It's not just their imports that they would accept from us, but it's their exports and the way they get there. The way they get there is far different from what we do and is not what we would consider a free market at all.

HIGH TECHNOLOGY STUDY BY THE CABINET COUNCIL

Representative HECKLER. Mr. Secretary, is it possible that this new study—by a segment of the Cabinet Council on Trade and Commerce on the issue of competitive position of U.S. high-technology industries—will result in any recommendations to Congress? We've heard about the problems that you've mentioned so often—and coming from a high-technology State, I'm extremely aware of them. The points that you have raised have been mentioned to me at home, by industry leaders. I've never heard an adequate response. Is it likely that the Cabinet is going to make some recommendations to the President or the Congress on that subject?

Secretary BALDRIGE. We'll have to see, Congresswoman, because the trouble in the past has been isolated comments, studies, statements on what actually happens. We have not been proceeding from an overall fundamental base of known facts that we can all agree are properly researched and studied. We are making a very large step in that direction with this study. It won't be finished for 2 or 3 months yet, and it's been going for 2 months.

So when we have those facts, then we will have to start to see how we translate that into policy. But I always hate to make policy without facts, and I think we have got to get those first, so we will have to see what comes out of it before we make any recommendations.

EFFECT OF ANTITRUST LAWS ON FOREIGN TRADE

Ambassador BROCK. There is an additional problem that I would just like to put on the record, and that is that we passed the Sherman Antitrust Act 70-odd years ago, on the basis of competition only within the United States. I think what we have failed to do is that we recognize that we live in a world now not contained by the Pacific and Atlantic Oceans, and it might be worth a look to see if, in fact our laws are adequately procompetition.

There would be a caveat to that. If, in fact, we are going to allow U.S. companies to cooperate, which they can't even do by law today to compete in the international arena—and part of that we have tried to address with the export trading company bill but it goes beyond that—if we're going to allow them to get together for international purposes, then we have to make an even more fundamental commitment to open markets. I think the two go together. You can't allow combinations unless you keep your markets open.

I do think that's a subject that requires a good deal more study as a part of not just high technology, but virtually all competitive areas. We have simply not looked at our laws to see if, in fact, they are adequate, and one of the frustrations I am sure Secretary Baldrige shares with me is with the Congress expressing all this concern about imports and exports in trade. This administration on the basis of not just its recommendations but those of a former Democratic administration, both of us have found barriers to trade that are imposed by us on us. Export trading companies legislation, Foreign Corrupt Practices Act legislation are still stalled in the Congress of the United States, and if the Congress wants to do something about it they can start right there.

Secretary BALDRIGE. Amen.

Representative HECKLER. The ball can be shifted from one court to another quite appropriately and fairly, I think. I am delighted that you're doing this study on high technology, Mr. Secretary, but I think a lot of the material has been gathered that is not necessarily essential. It is important to have the facts, naturally. But I would hope—bearing in mind that we're not going to subsidize high-technology companies, no matter what their market share happens to be, or how diminishing the return becomes, but also realizing that there are avenues such as tax changes and antitrust changes—what I would hope is that we would definitely develop some hard recommendations. And I think those recommendations should have your strength behind them, both of your strengths behind them, with the idea that the attitude in America has changed.

We have considered our advocacy of free trade to the point where we feel it has become extremely unfair toward the American industries and to the American worker. We are very serious—this is not rhetorical—in saying that the American worker is simply becoming fed up. They want fair trade. I think there is a time to advance something to go beyond the point of discussion. And hopefully you will have an agenda for action for the Congress.

Secretary BALDRIGE. Yes, I didn't mean to imply that we were just going to do the study and not have any recommendations. That's the purpose of this study.

BALANCE IN HIGH TECHNOLOGY TRADE, UNITED STATES VS. JAPAN

If I may just quote a couple of figures here because these are very striking to me. If you took the cumulative trade balances in technology-intensive-manufactured products from 1971 and 1975, for the United States and Japan, the United States had a trade balance, 1971 to 1975, of $77 billion and in 1976 to 1980—that cumulative 4-year period, so these stretch over the decade, the first and the last half of the decade of the 1970's—we had $154 billion, so the United States went from $77 to $154 billion. Japan had $37 billion in the first half, and in the second half they had $275 billion. They went in high technology intensive, or technology intensive—not all of this is high technology, because part of it's automobiles—Japan went from $37 billion to $257 billion between the first half and the last half. We went from $77 billion when we were ahead, to $154 billion.

Those figures, translated into jobs, are startling; 3 million-plus jobs, any way you want to measure.

Representative HECKLER. Congressman Richmond, I would hope that we would have another meeting on the subject when the council reports, because frankly, I just think the American people are fed up. I really do think this is a terribly serious problem, that it's not one that's relegated to just a few sophisticated industrial leaders but is quite commonly understood on Main Street. It translates into jobs at a time when our economy hopefully is seeing maybe a little light at the end of the tunnel, because I have hope in your figures. I have a lot of confidence in you. But I feel that American workers feel there's a great deal at stake in trade negotiations today, and they are following them closely. And frankly, I think the Congress has the responsibility to do something.

Secretary BALDRIGE. We agree.

Representative RICHMOND. Thank you, Representative Heckler.

Ambassador Brock, Secretary Baldrige, Under Secretary Olmer, thank you for coming. We always learn so much when you do come. Thank you very much.

[A brief recess was taken.]

Representative RICHMOND [presiding]. Our next witness is Dave Stockman. But before we proceed, I will include the opening statements of Senator Hawkins and Senator Mattingly for the printed record.

[The opening statements of Hon. Paula Hawkins and Hon. Mack Mattingly follow:]

Opening Statement of Senator Hawkins

I think it is very important that proper government action be taken to stimulate necessary economic growth. To that end, I am a cosponsor, with Senator Kasten, of a proposal to accelerate the tax cut.

It is time to get America back on its feet. Strong incentives for growth are needed to decrease interest rates and encourage economic growth.

Now some may say that this is no time to drive up the deficit; it's too big already.

However, I believe it makes a difference how deficits are created. Interest rates could go down, not up, when a deficit is created by cutting taxes in ways that stimulate savings. It has been called by some "crowding in." If accelerating the tax cut now were to increase the deficit by $20 billion, while increasing savings by $30 billion, then there would be $10 billion of net new funds to finance investment and new jobs. We need to consider carefully all tax proposals which might achieve this. Thank you.

Opening Statement of Senator Mattingly

Mr. Stockman, I welcome you to the Joint Economic Committee to testify on the administration's efforts to revitalize our ailing economy. The administration's proposal is an aggressive, comprehensive, and equitable measure, one designed to reverse the past policy failures.

We obviously did not get to the brink of economic bankruptcy overnight. Our current economic woes are the result of poor policy and planning of past administrations, both Republian and Democrat. The fiscal year 1981 spending habits which the current administration inherited were indicative of the extravagance and uncontrolled spending habits of past administrations.

In order to return our economy to a state of economic sanity, we must continue to reduce the future growth of Government spending. Controlling Government spending is a necessary step on the road to economic stability, one which has been totally neglected during past decades. Clearly, the current recession, which has resulted in intolerably high unemployment and the rollercoaster economic conditions of our past, are the result of uncontrolled Government spending and are further aggravated by the increasing Government confiscation of American workers' paychecks. A reversal of such trends was long overdue and addressed by the administration.

Mr. Stockman, I must admit that I, too, am concerned with the high deficit figures projected for the next several years. I applaud the administration's efforts to control these deficits, for without an aggressive and comprehensive budget savings plan, the deficit would rise to even higher levels. We must continue to fight the problem of high projected deficits. In doing so, I would suggest that the administration go back to the drawing board and come up with additional larger reductions in the bloated Federal budget.

I find it ironic that the Members of Congress hollering the longest and loudest about the projected deficits are those who have advocated spend, spend, spend and tax, tax, tax in the past. If these "born again budget balancers" are so concerned with present and future deficits, we welcome their contribution to reducing the growth of future Government spending. I am afraid the truth of the matter is that they are more interested in exploiting public opportunities for levying criticism than bringing Government spending habits to a reasonable level. In fact, total proposed spending for fiscal year 1983 is greater than that in fiscal year 1982. The budget reductions contained in the administration's package are not actual reductions in Government spending as many of the horror stories we read in the papers today would indicate. Instead, it is an effort to control the future growth of Federal expenditures. Such efforts on the part of the administration are aimed at bringing the budget under control.

I am also concerned and dismayed at the rhetoric also coming from the opponents of the administration's program which say that the way to fight deficits is to raise taxes. Whether you raise taxes or delay future tax benefits, such efforts are only a retreat to the policies of the past decade which have proved to be a failure and have produced the economic woes which exist today.

The comprehensive tax reductions we passed last year were long overdue. Business production had been stifled because of out-of-date equipment and tools as the result of out-of-date depreciation schedules. The Government hand in the hip pocket of the individual taxpayer had reached an unconscionable level. Such conditions could only lead to an economic stalemante, and that is exactly what happended. The tax reforms of last year will reverse the economic stalemate and will stimulate savings, investment, and business expansion, all of which are necessary to promote an economic bonanza. Therefore, I hope the administration will stand firm in its commitment to future tax reductions for individuals and businesses.

Mr. Stockman, I look forward to working with you and the administration in an effort to return the American economy to one of economic growth and prosperity. Last year's successes were only a step in the right direction toward this goal. Now is not the time to undo our efforts of last year.

Representative RICHMOND. Good afternoon, Mr. Stockman. We have your prepared statement, plus your addenda, which will appear in the record in toto.

We would be most grateful if you would just make as many remarks for as long as you would like.

STATEMENT OF HON. DAVID A. STOCKMAN, DIRECTOR, OFFICE OF MANAGEMENT AND BUDGET

Mr. STOCKMAN. Thank you, Congressman. I do have quite a lengthy prepared statement, and I think it would be more useful to you and other members of the committee, when they return, to engage in the dialog here this afternoon, on the basis of this budget and its contents. I would just ask that it be submitted for the record and spend a few moments providing some highlights of the budget policy proposals that I think would be useful to underscore and stress. Then I would be happy to take your questions and the questions of other members, as they arrive.

THE 1983 BUDGET FIGURES

I think the place to start is with the budget aggregates and with the 1983 budget, because that is the live proposal before this committee and the Congress today. Of course, those numbers are well known by now. The budget provides for outlays of $758 billion, receipts of $666 billion in 1983, and a deficit of $92 billion. The most obvious characteristic of these numbers is that they are all numerically large, but I think the most important attribute rather than simply the surface characteristic is how we get there, and I want to spend a few moments describing some of that.

I think the first point to note is that the $758 billion outlay level represents an increase of only $32 billion from the outlay level that we're projecting for the fiscal year 1982 budget, an outlay level that has been swollen in recent months by the impact of recession. If we are able to implement all of the spending and entitlement reduction measures in this budget, we would, therefore, hold the aggregate increase in spending in fiscal year 1983 to the smallest absolute dollar increase since fiscal year 1974.

Second, while the deficit at $92 billion is too high, the fact remains that it is substantially smaller, relative to GNP, than the comparable recovery year deficit of fiscal year 1976. The deficit to GNP ratio will be 2.7 percent in 1983, compared to the much larger 4 percent figure in 1976. If you were to superimpose that 4 percent on the current size of the economy and credit markets, you would be talking about a deficit somewhere in the range of $139 billion in 1976.

SOURCES OF THE LARGE PROJECTED DEFICIT

Congressman, this is not to say that even though this $92 billion deficit is a transition deficit that merely reflects the first year coming out of a severe recession and that has some built-in momentum that takes time to correct. This is not to imply that a deficit of this size is desirable or benign in any way. It only suggests that we need to put this in perspective if we are to grapple with the problem that we face as an administration and a Congress, as we seek to chart a fiscal course for this coming fiscal year and the future. We need to understand its relative dimension, as well as its absolute significance.

These numbers reflect that the runaway spending momentum we had during the 1970's, in particular 1977 to 1981, has been decisively reversed. The budget is being brought under control for the first time in more than a decade.

Proposed outlays for fiscal year 1983 are up 4.5 percent. That is one-half of the 1982 increase in outlays, even with the recession bulge, and only one-fourth of the peak spending growth rate of 17 percent recorded in fiscal year 1980, when spending was truly out of control.

To put it in another perspective, the percentage increase in the budget that we have proposed for fiscal year 1983 is the lowest annual rate of increase that we have seen in any budget since fiscal year 1969, which was a decade and a half ago.

The point here is simply to stress that, in the past, large deficits have occurred automatically, and I think appropriately, equated with the notion that the budget is out of control, and there is no fiscal discipline nor fiscal plan. Clearly, present deficits can in no way be equated with the kind of deficits that we had in the past, insofar as their source, underlying momentum and contributing factors are concerned.

PROPOSED BUDGET COMPARED WITH CURRENT SERVICES

I think the third point to underscore for this committee is the fact that these numbers, as high as they are, are the aggregates for fiscal year 1983, which can only be achieved with implementation of a sweeping five-part program to close the budget gap. Without these measures in the entitlement area, the discretionary area, the user fees, the tax loophole closings, corporate minimum tax, and the management initiatives that we intend to largely initiate from the executive branch and will need some legislative change to support, the deficit would be a staggering $150 billion in fiscal year 1983, and would rise as high as $170 billion in 1984 and 1985.

The current services deficit projection, without new policy action and without a determined and comprehensive effort to deal with the fiscal circumstances we have at the present time, consists of deficits that are incompatible with the economic recovery that we expect and want. Rather than moving down steadily over time, the underlying or built-in current services deficit is high and continues to rise in future years. This signifies the importance of the plan that is provided in this budget: To substantially reduce the initial deficit level in 1983, and to keep it moving down as the savings that we would realize from these initial measures become increasingly larger in the future.

All told, this budget provides a pathway or a blueprint to reduce $56 billion from that current services deficit in 1983, $84 billion in 1984, and nearly $100 billion in 1985. We seek the support and cooperation of Congress on implementing more than $239 billion in reductions over the next 3 years. The action plan is balanced and across the board, addressing every front in the budget where savings or reductions are possible. The plan could reduce the current services deficit by 50 percent over the next 3 years. It solves half of the problem. That's why this program is so important and why we so urgently seek the help and the support of the Congress again this year.

A FIVE-PART PLAN TO CUT THE DEFICIT

The fourth point is that the proposed 1983 budget is a comprehensive and balanced plan to try to close the deficit gap wherever action is possible, desirable, or justifiable. The $56 billion in savings for fiscal year 1983 encompasses five areas, and I would just like to outline them very briefly for the committee. As you continue your deliberations, you may come up with different numbers or a different mix, but we believe very strongly that this five-part framework at least provides a conceptual framework in which the job of quickly reducing these deficits can be pursued.

MANAGEMENT SAVINGS

Part 1 encompasses management savings of nearly $20.3 billion in 1983. It includes intensified debt collection, for which we will need action in Congress on legislation that we have had pending for some time. It includes an aggressive and comprehensive effort to dispose of surplus property, which will require legislation in some cases. It includes the increased receipts that we will realize from the accelerated offshore leasing program that has been instituted by this administration. It includes strengthened IRS revenue collection programs through changes in the law and increased staff. It includes a Federal pay cap of 5 percent in fiscal year 1983: a further effort to hold down total budget outlays.

ENTITLEMENT CHANGES

The second category of this five-part framework for closing the budget gap includes nearly $12 billion in further entitlement reforms spread across almost the entire array of non-social security entitlements. It includes additional steps that we believe can and should be taken to tighten the food stamp program without depriving those who do need those benefits. It includes cost containment measures in the medicare and medicaid program that will largely fall on the provider side, but to some degree will also require increased participation by beneficiaries. It includes long overdue caps and reforms of the COLA for Federal military and civilian retirees, as well as other measures that we can talk about in more detail at a later point.

Moreover, fiscal year 1983 savings of $12 billion a year, which result from law changes or changes in the structure of these entitlements, will grow substantially, in the outyears. If these measures aren't adopted, approximately $52 billion will be spent over the next 3 year.

DISCRETIONARY PROGRAM CUTS

The third area includes discretionary program reforms, cuts, holddowns, and consolidations, which are outside the entitlement structure of the domestic budget. If these measures are achieved in the appropriations process, we could save $14.2 billion in 1983.

TAX CHANGES

The fourth area consists of the Tax Code revisions that the President has proposed. Those fall basically into two categories. The strengthened corporate minimum tax would generate about $2.3 billion in receipts. Various loophole closing measures would eliminate obsolete incentives in the Tax Code and would largely affect businesses that are no longer relevant or timely, given the sweeping restructuring of the business tax system that was adopted by the Congress last year.

USER FEES

And finally, the fifth area includes a variety of proposals for user fees, so that the Federal Government will recover costs from those who benefit from services that are directly attributable to them.

The fifth point is an important point. The source of these deficits, as large and undesirable as they are, is not uncontrolled spending. Nor is it the traditional implication that spending will continue to rise at rapid, uncontrollable, and unsustainable rates in the future.

DEFICITS COMPARED FOR 1975–78 AND 1982–85 CYCLES

If we compare these deficits over the 1982–85 recession and recovery cycle with deficits over the 1975–78 business cycle, we see a totally different pattern. This, I believe, is important to underscore. The deficits over the 1975–78 period were driven by a rapid acceleration of spending growth and new budget commitments. The deficits were driven from the outlay side, which increased the problem of bringing them under control and reducing them in out years.

Total spending, after stripping away inflation during that 1975–78 cycle, grew at nearly a 4-percent annual rate. Nondefense spending grew at a rate of more than 5 percent in real terms each year. Enormous outlay momentum was built into the budget and the prospect for controlling and reducing deficits, as the economy recovered, as business activity increased, as receipts recovered, was much less promising.

The fiscal year 1982–85 deficits, by contrast, are driven primarily by adjustments in the economy to the steady reduction of inflation and by the slow process of paring back past spending commitments, rather than by the creation of future spending liabilities.

In contrast to 1975–78, the real spending growth rate will average only 0.4 percent during the 1982–85 period if the measures I have just outlined are adopted by the Congress. Nondefense spending will actually decline at an average real rate of 2.6 percent each year over the next 4 years.

Thus, the 1982–85 deficits arise from an environment of economic recovery, disinflation, and shrinkage of future budget commitments. The outlay and revenue paths will converge over time, rather than diverge, as they did in the 1975–78 period.

CONTRIBUTION OF RECESSION AND LOWER INFLATION TO CURRENT DEFICIT

Representative Richmond, I have one final point. It concerns why these numbers look so different and why the deficit problem is so much more severe today than we expected a year ago as we launched this program.

The large deficits currently projected, compared to the original administration estimates of about a year ago, are entirely due to changes in the economic assumptions and to the budgetary impacts of the economy's transition to a path of lower inflation, sustained real growth, and financial equilibrium.

In combination, the recession and the more-rapid-than-anticipated fall of inflation which has occurred this past year will substantially reduce nominal GNP as compared to the administration's original forecast.

Nominal GNP will be $176 billion lower in fiscal year 1983, and $267 billion lower by 1986. That does not represent less expected real growth and real prosperity. It represents primarily a one-time downshift in the level of the economy that was caused by the 1982 recession, and a more-rapid-than-expected progress on the inflation front, which reduces the inflation components of incomes, profits, and the level of national income.

And as a result of these favorable changes, the level of projected receipts in fiscal year 1982 and beyond will be lower because receipts are entirely driven by the level of nominal GNP.

Currently the tax bill is not based on real income. It is assessed on nominal income, which is driven by a combination of inflation and real growth. As a result of this substantially lower path of nominal GNP, the receipt projections have been substantially revised.

At the same time, the financial adjustments to a steady slowing of money growth and of inflation rates will result in a slower decline in interest rates than originally projected. This will add substantially to debt service costs for several years: $33 billion this year, and substantially more in the future.

Also, even as inflation comes down faster than had been projected or anticipated, the outlay savings that we can expect from lower cost-of-living adjustments—COLA—will lag behind the fall of the inflation rate and the fall of receipts. COLA's are determined by base periods that are between 12 and 24 months preceding the actual month in which these adjustments are paid and become cash outlays on the budget.

The process of disinflation creates a temporary fiscal predicament in which receipt growth slows immediately in response to lower inflation components and taxable income, while the outlay growth response is delayed by high debt service costs, the lag in COLA adjustments, and the built-in momentum on the outlay side of the budget equations.

Higher interest rates increase fiscal year 1983 outlays by $31 billion. Lower nominal GNP reduces receipts by about $51 billion, shifting the budget from near balance to the $92 billion figure that we have presented to the Congress.

Deficits beyond fiscal year 1983 are also entirely attributable to these changes in the outlook through time and the performance of the economy: for the level of nominal GNP and the level of real and nominal interest rates.

In fact, the fiscal year 1983 budget provides more than the $30 billion for 1983 and the $44 billion for 1984 in future budget savings that were originally part of our plan and were essential to keep it on track.

In the material that I have submitted to the committee, Representative Richmond, we have provided alternative projections of the budget, one with our current forecast, with deficits of $99 billion in 1982, $92 billion in 1983, $83 billion in 1984, and $72 billion in 1985; and one with the original economic assumptions with deficits of $42 billion in 1982, $2 billion in 1983, and surpluses thereafter.

Huge changes in the budget totals that result from economic shifts seem rather hard to comprehend or believe, but that is precisely what has occurred.

As we move this economy from low growth, high inflation, and worsening financial disorder to increasing financial stability, there are going to be transition effects on the budget. The imbalance between spending commitments and the revenue structure that we have to finance them occurs as this $3½ trillion economy moves from a clearly unacceptable path to one that hopefully will be much more prosperous and stable in the future.

I know that this committee has a special interest in not only macroeconomic policy, but also in the macrodimensions of fiscal policy in the budget as a whole.

I would encourage this committee to take a very careful look at the trends I have outlined today, and the new and unexpected forces working through the budget, in order that you might better guide your colleagues in the Congress in helping us come to a solution of what is a large problem, that can and might be in order to keep the program on track.

Representative Richmond, those are my opening remarks, and I appreciate very much your indulgence in permitting me the time to go through them. I would be very happy at this point to take your questions and questions from other members of the committee.

[The prepared statement of Mr. Stockman, together with the additional material referred to, follows:]

PREPARED STATEMENT OF HON. DAVID A. STOCKMAN

Mr. Chairman and Members of the Committee

Thank you for the opportunity to appear before your Committee this morning to present the President's Budget for Fiscal Year 1983.

It would be perfectly appropriate, Mr. Chairman, to classify the President's Fiscal Year 1983 budget as the most difficult set of budget options ever presented to the Congress. In large part this difficult predicament is a function of the unique interaction of inherited economic programs and redirected national policy objectives which set the fiscal backdrop for this year's budget presentation.

Previous government efforts to manage the economy through a mixture of excessive spending, taxing, borrowing and fine-tuning have exacted a heavy toll of lost economic growth. The recession in which we find ourselves today is the inevitable result of these past policy errors.

In a practical sense it is reasonable to argue that since early 1979 the economy has been mired in recession, where the level of industrial production has fallen by 5.7%, annual rates of real growth and productivity have advanced by only 0.4% and 0.5%, respectively, and unemployment has averaged an unacceptably high of 7.4%.

In response to this inherited recession, the Administration has consicously redirected economic policy toward a new mix of strict budget control, incentive-minded tax reduction, deregulation and moderate monetary growth. One of the key objectives of this new policy -- and an area of significant success in 1981 -- is the firm resolve to steadily lower the inflation rate during the years ahead.

For the first time since 1976 the key inflation indexes have shown sustained progress, where the consumer price index on a fourth-quarter-over-fourth quarter basis declined from 12.6% in 1980 to 9.4% in 1981, and the producer price index during the same interval eased from 12.5% to 7.2%.

Yet these two economic developments -- the first a product of past failures and the second an early indication of new policy successes -- have interacted to cause a major deterioration in the Nation's fiscal position. The unexpectedly large drop in inflation has generated a slower than anticipated growth of nominal GNP and, therefore, a reduction in taxable incomes and receipts.

However, outlay benefits from lower inflation are significantly delayed by locked-in costs of higher debt service, the lag in COLA adjustments, as well as other sources of carry-over spending momentum. Thus, when coupled with this disinflation process, the forces of recession have released a combined series of fiscal effects which are likely to worsen the Federal deficit in 1982 by $32 billion in lost revenues, $17 billion in higher debt servicing expenses and $8 billion in unemployment outlay increases.

As part of the Administration's firm resolve to continue the fight against inflation, nominal GNP growth during the 1983-87 period is expected to show a moderate and steady decline, corresponding to the moderate monetary policy expected to be carried forward by the Federal Reserve, and the associated decline in inflation premiums and interest rates.

This is a marked departure from past pump-priming exercises, but it is an integral part of the President's fundamental reordering of macroeconomic policies and priorities. This process of disinflation, however, creates a difficult if transitional fiscal predicament which will substantially reduce future nominal GNP levels by $176 billion in 1983, aggregating to $267 billion by 1986, in relation to last year's estimates.

In total, as a result of economic influences 1983 estimates now have been revised to increase the projected deficit by $90 billion, and by $91 billion in 1984 and $93 billion in 1985. This is despite the fact that the 1983 budget plan provides more than the $30 billion in 1983 and $44 billion 1984 future budget savings originally targeted in the Administration's 1982 plan, and despite the fact that when the newly proposed spending reductions are combined with those enacted last year, the rate of growth of Federal outlays is expected to fall from the 17.4% pace of 1980 to about 4.5% by 1983.

Further complicating the fiscal picture are two additional key elements of the President's fundamental reordering of economic policies and national priorities. First, since the 1970's the U.S. has allowed its military power to decline relative to its national interest and the growth in military power of the Soviet Union.

To correct for this serious underinvestment in national security, the President has requested that the defense share of the budget rise from a post WW II low of 24% in 1980 to 29% in 1983 and 37% in 1986. Total obligational authority in 1983 is projected to rise by $43.7 billion to $258 billion, while outlays are estimated to increase by $33.1 billion to a level of $215.9 billion.

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A second key element of the Presidential reordering of priorities is the marked reversal in tax policy. To achieve new incentives for saving, investment and productivity, without which sustainable economic recovery would not be possible, the Administration is firmly committed to keeping in place all of the provisions of the Economic Recovery Tax Act of 1981. This pledge includes the planned reductions in marginal tax rates, the accelerated cost recovery system, the individual saving incentives such as Keough and IRA accounts, and the permanent indexation of future taxes starting in 1985.

These tax policies serve the dual purpose of removing the inflated revenue base which permitted continued excesses in Federal spending, thereby disciplining future spending, as well as to improve the after-tax rate of return on investment and work effort in order to foster new entrepreneurship, risk taking and capital formations.

However, the economic combination of recession and lower inflation, along with a fundamental reordering of national priorities toward reduced government, continued anti-inflation resolve, investment oriented tax incentives and a stronger and more modern defense capability, has created what may be viewed as the most difficult fiscal framework ever presented to Congress. This difficult situation is well illustrated by a review of the budget aggregates.

THE BUDGET AT A GLANCE

(BILLIONS OF DOLLARS)

ITEM	FY '82 ESTIMATE	FY '83 ESTIMATE	FY '84 ESTIMATE	FY '85 ESTIMATE
RECEIPTS	627	666	723	797
OUTLAYS	725	758	806	868
DEFICIT	−99	−92	−83	−72

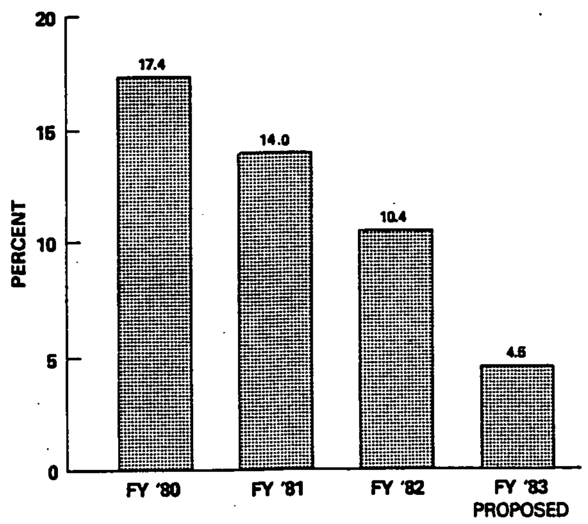
First, the President's budget shows significant progress toward restraining outlays. Between the budget of 1982, which has been bloated by expenditures cause by the recession, and 1983 outlays, the increase is only $32 billion. That is the smallest increase in the budget since 1974.

The deficit projected for 1983 is $92 billion. This is a high figure, but it needs to be put in perspective in terms of the size of the economy. It represents a substantially smaller share of GNP than did the deficit during 1976, a similar recovery year; 2.7 percent in fiscal year 1982 versus 4 percent in fisal year 1976 when the economy was moving along almost the same recovery path that we are projecting for fiscal year 1983.

If the 4 percent deficit in 1976 were superimposed on the size of the economy that we have today, it would have been in the range of $139 billion.

The next chart indicates in more detail a point that we think is crucial and significant about this budget, and that is that it continues a process of dramatic decline in the spending rate.

DRAMATIC DECLINE IN SPENDING GROWTH
1980-83



The reason that I call this to your attention this morning is that there has been a tendency in the past, and that tendency probably was accurate and appropriate, to equate large deficits with a generalized notion that the budget was out of control evidencing runaway spending. This isn't the case in the current climate with the projections and proposals we have made. Instead, the spending trend, the outlay side of the budget, is moving dramatically in the opposite direction.

If all of the outlay and entitlement savings proposals we have proposed are approved, the spending growth rate will drop to 4.5 percent in 1983. That is below the expected inflation rate, which means that in real terms, federal spending is declining. This is less than half the recession year 1982 growth rate and almost a fourth of the peak spending growth rate that we had in 1980 when the budget was truly out of control.

The major point is that the deficits we are projecting have a different cause and a different significance. They arise from a different fiscal environment. The deficit is largely a product of the transition from past fiscal policy and economic conditions to a wholly new economic environment in which inflation will be declining steadily and growth will recover; in which financial markets will slowly adjust and interest rate premiums will slowly come down; and in which past spending commitments will steadily shrink.

Of course, that is the exact opposite of what happened during the 1975-1978 cycle, when the inflation rate got steadily worse, financial disorder got steadily worse, the spending growth rate got steadily higher, and everything was moving in the wrong direction.

The next chart captures in about nine numbers where the budget would have been if no additional measures had been proposed on either the outlay or the revenue side of the budget.

FIVE-PART BUDGET SAVINGS PLAN

(BILLIONS OF DOLLARS)

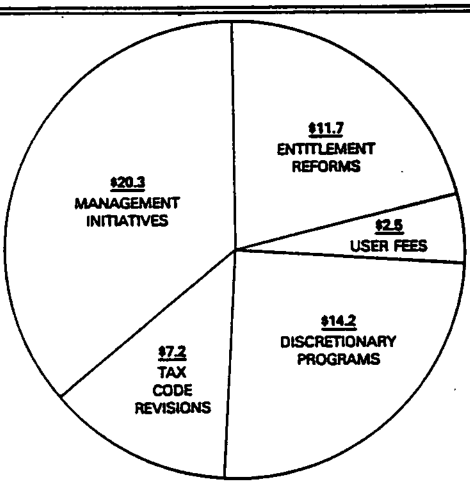
	FY '83	FY '84	FY '85
DEFICIT WITHOUT SAVINGS PLAN	−147	−167	−171
FIVE-PART DEFICIT REDUCTION PLAN	+56	+84	+99
PROPOSED DEFICIT WITH REDUCTION PLAN	−92	−83	−72

The first line on the chart is the deficit that would occur if no additional policy action were proposed. As you can see, those deficit numbers are consistent with many of the dire forecasts we have all heard recently. They compellingly point out the consequences of continuing the current policy, and of not taking further actions to close the gap.

With this budget, we are presenting a five-part plan to steadily reduce that deficit gap after the recession year budget of 1982 ends.

Total savings from the tax revisions, entitlement reforms, user fees, management initiatives and discretionary program holddown will rise from the $56 billion in savings we are proposing for Fiscal Year 1983 to $99 billion by Fiscal Year 1985.

FIVE-PART BUDGET SAVINGS PLAN
— FY '83 —
(BILLIONS OF DOLLARS)



TOTAL: $55.9

The next chart provides a quick overview of the composition of the $56 billion savings. There are five distinct categories, the first of which is a variety of management initiatives. Some require legislation. Many do not. In combination, they would produce $20 billion worth of savings in current services.

They include intensified debt collection, surplus property disposal, accelerated offshore oil leasing, strengthened IRS revenue collection programs, a five percent cap on Federal pay increases, and a variety of other measures.

The second major category includes entitlement reform and retargeting proposals. These proposals generate savings of $11.7 billion in the first year. Most of these changes are very small and involve many programs. The major elements are: changes in the Medicare and Medicaid program, further changes in the Food Stamp program, a cap on Federal retirement COLAs, and a variety of other changes in the Guaranteed Student Loan and other programs.

The third category, discretionary programs, involves $14.2 billion in budget savings. It covers almost every area subject to annual appropriation -- manpower, education, nutrition business subsidies, energy subsidies, and a host of other areas.

The fourth category is the tax measures, which equal $7.2 billion in 1983, and the fifth user fees, many of which we proposed last year and are reproposing this year, and some of which are new.

Before I go to the details of each of those slices of the pie, I just want to make one additional comment about the deficit path that we have charted in the budget proposals that we are making.

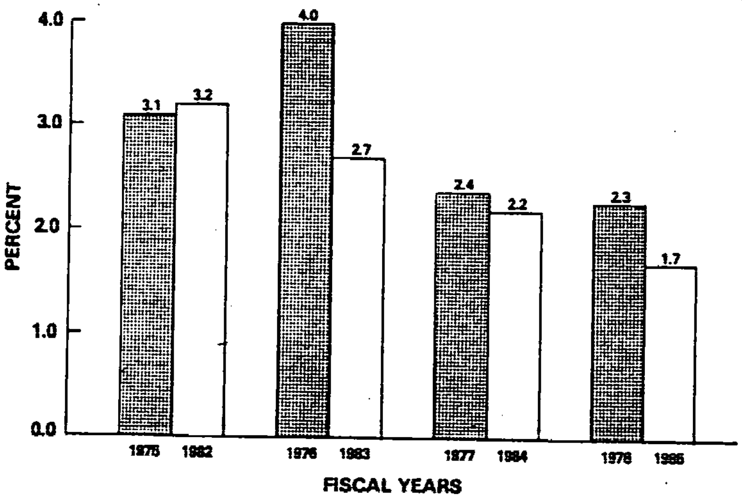
This chart is not necessarily a statement of policy, because obviously all deficits to some degree are worrisome. But it is a commentary about numbers, and about responsible discussion of the deficit that I think is important to raise at the onset of the discussion we will have over the FY 83 budget in the ensuing weeks.

Many of the descriptions of the expected deficits that I have ready are accompanied by horrific adjectives: staggering, towering, gigantic, huge, et cetera. But those terms are accurate only if you ignore the fact that there has been enormous change in the scale of numbers that we worked with over the last four or five years.

They are not huge in the context of a $3.3 trillion economy. Rather than comparing these projections to the past, they must be put in the context of the scale of numbers that we have in the economy today.

DEFICITS AS A SHARE OF GNP IN RECESSION/RECOVERY CYCLES

(1975-78 VS. 1982-85)

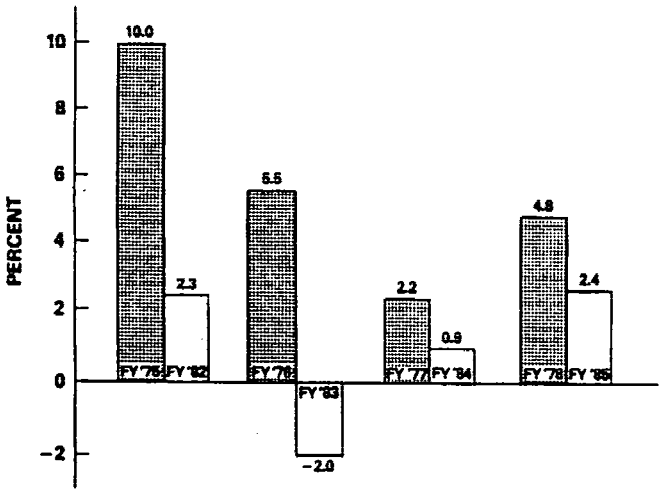


If we were to superimpose the last recovery and recession cycle over the present one, you will see that the deficits we are projecting after all of the policy action is completed are actually smaller in almost each year except for the recession years 1975 and 1982. In those years the difference is marginal. But there is one other difference that has far more significance than simply matters of scale. That is that deficits we project for 83 - 87 occur for far different reason than during the last recovery cycle.

The 1975 to 1978 deficits were driven by the rapid acceleration of spending growth in new budget commitments. The total spending after inflation during that four-year recession-recovery period grew at almost four percent. Non-defense spending during that period grew at better than a five percent real rate.

By contrast, during the current recession-recovery period, for which we are projecting the budget, the real spending growth rate in total will average less than four percent and non-defense spending will actually decline at a 2.6 percent real rate each year. As a result of that there are totally different factors shaping the budget. There are totally different implications for the budget in the future in terms of our ability to control and steadily reduce the deficits.

REAL SPENDING GROWTH RATES
FY '75-78 VS. FY '82-85



The next chart provides the three-year budget numbers the Congress will be dealing with very soon. It describes the five major areas in the budget where we believe actions can be taken to bring the deficit steadily down.

FIVE-PART BUDGET SAVINGS PLAN
— FY '83-85 —
(BILLIONS OF DOLLARS)

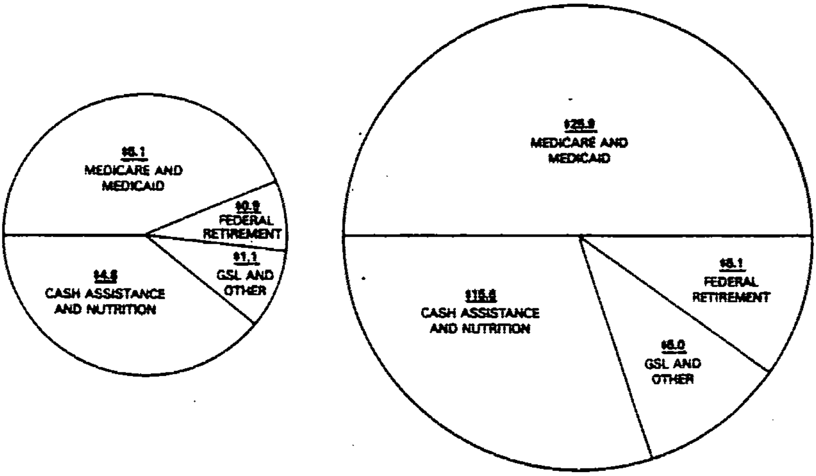
	FY '83	FY '84	FY '85	TOTAL	SHARE
ENTITLEMENT REFORMS	11.7	17.1	22.8	51.6	22%
USER FEES	2.5	3.5	3.8	9.8	4%
DISCRETIONARY PROGRAM CUTS	14.2	26.1	35.3	75.6	32%
MANAGEMENT INITIATIVES	20.3	24.0	23.9	68.2	28%
TAX REVISIONS	7.2	13.5	13.5	34.1	14%
TOTAL	55.9	84.1	99.3	239.3	100%

I think you can see that this is a pretty large, sweeping and impressive program, one that divides the responsibility for bringing the budget into balance across almost every area of the budget. Over the three years, it provides $239 billion worth of savings relative to what would happen if we simply gave up now and allowed the budget to careen forward on its own momentum.

I will now review these five major points of the budget savings plan to give a closer look at the sorts of changes we are proposing.

ENTITLEMENT REFORMS

(BILLIONS OF DOLLARS)



FY '83: $11.7 FY '83-85: $51.6

In each of these charts, savings are shown for 1983, then the cumulative savings over the three-year period are provided. I will focus on 1983. Of the $12 billion of proposed savings, $5 billion will come out of the medical programs. There are four essential features of the numerous changes we are proposing. One is a series of new measures to tighten reimbursement controls on providers in the Medicare and Medicaid program. We propose to reduce the projected increase in maximum physician fees that Medicare will reimburse from 8 percent to 5 percent.

We will reduce the otherwise applicable reimbursement rate to hospitals under Medicare by 2 percent.

We will alter or revise the manner in which radiologists, pathologists and other hospital-based physicians are reimbursed, and include a variety of other lesser changes to contribute to the substantial volume of savings.

On the beneficiary side, there will be a proposal for nominal copayments under the Medicaid Program to reduce participation or excessive utilization, and a proposal to index the deductible under Part B for Medicare to the inflation rate each year.

A third major area in the proposed savings includes coverage of Federal employees under the hospital insurance tax. That would bring in about $600 million in 1983 and $900 million by 1985. The reason for this is that, as time passes, Federal employees are eligible for and benefit from the Medicare Program, and we believe it is necessary now for them to start contributing.

There will also be major changes proposed later in terms of the fundamental reimbursement system that will be part of our pro-competition proposal. That is not included in the budget transmittal at the present time, but it is nearly completed after a year's work and will be proposed later.

In cash assistance, which is the next major proponent, there will be some modest changes in the SSI Program to tighten disability definitions, and changes in AFDC oriented toward tightening the workfare provisions of last year, and broadening the income test to include all household members and all household income.

A third major category of the entitlement reforms is in the area of Federal retirement. We propose a twofold test to determine the annual cost-of-living adjustment.

First, the adjustment would be the lower of the actual Federal pay raise granted during that year to active members of the Federal Executive Service or the CPI, which we now use.

Second, caps will be proposed on the CPI for Federal retirees who have benefits that are disproportionate to the annuities that would be received by people retiring today.

In the Food Stamp and Nutrition area, there are a number of changes. One change is to increase the expected food contribution to 35 percent of net income.

The second change would be to eliminate the special disregard of earned income in calculating benefit levels.

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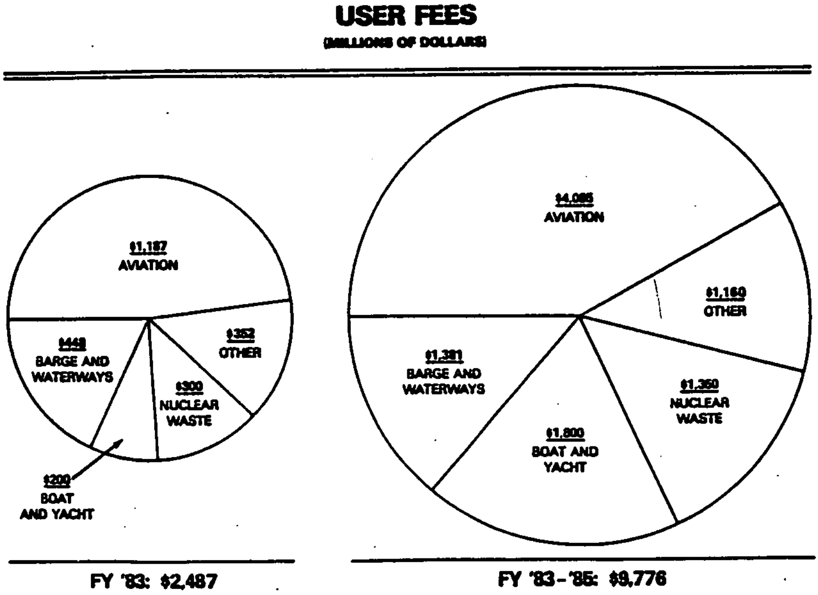
The third major reform would be mandatory job searches for able-bodied food stamp applicants.

A smaller part of the entitlement reforms consists of additional changes in the Guaranteed Student Loan program. Again, reform would target the program to those with incomes under $30,000 and who demonstrate a financial need. It would limit access to the program for those who are beyond their undergraduate years.

The next set of proposals involves user fees.



The most important initiative is the aviation user fee we proposed last year and are proposing again. That is designed to recover 85 percent of the cost of the air traffic control system to those who benefit from it and have their safety protected by it.

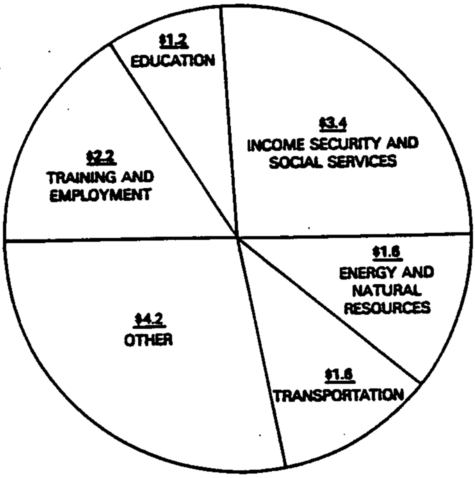
It would involve a 8 percent passenger ticket tax and some increases in general aviation gasoline and jet fuel taxes.

The other major proposal is the Corps of Engineers navigation fees, to recover the cost of construction and operations and maintenance on the inland and deep draft waterways.

A new proposal involves about $300 million a year that would be collected from the electric utilities in order to fund the radioactive waste disposal programs we are going to need in the future.

DISCRETIONARY PROGRAMS

(BILLIONS OF DOLLARS)



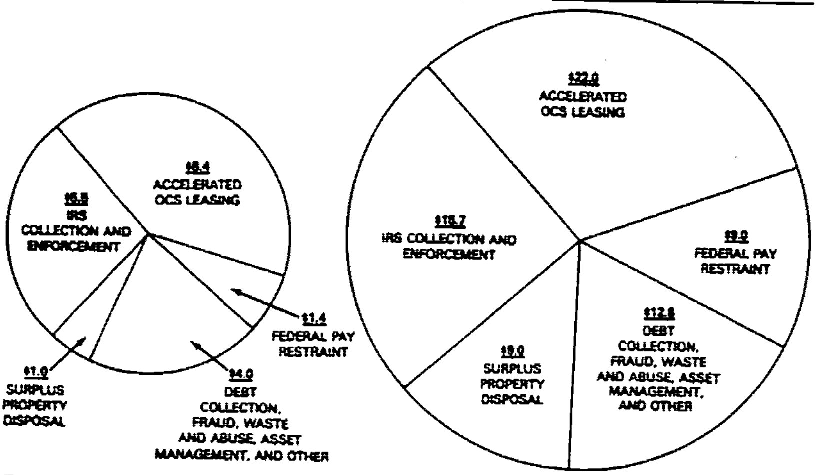
TOTAL: $14.2

The third area of the five-part plan covers additional changes in discretionary programs. Since there are literally hundreds of these, I will not attempt to go through all of them here. Most of the $14.2 billion in savings are not a result of new program cuts from last year's appropriated level for 1982, but simply reflect the absence of a cost-of-living or inflation increase for those discretionary programs in 1983; in other words, we are holding them at the 1982 level or slightly lower.

The next table and chart covers the management initiatives and, as I have indicated before, we will propose a wide range of activities. The pie chart provides an overview of the main areas where we believe significant savings can be achieved.

MANAGEMENT INITIATIVES

(BILLIONS OF DOLLARS)

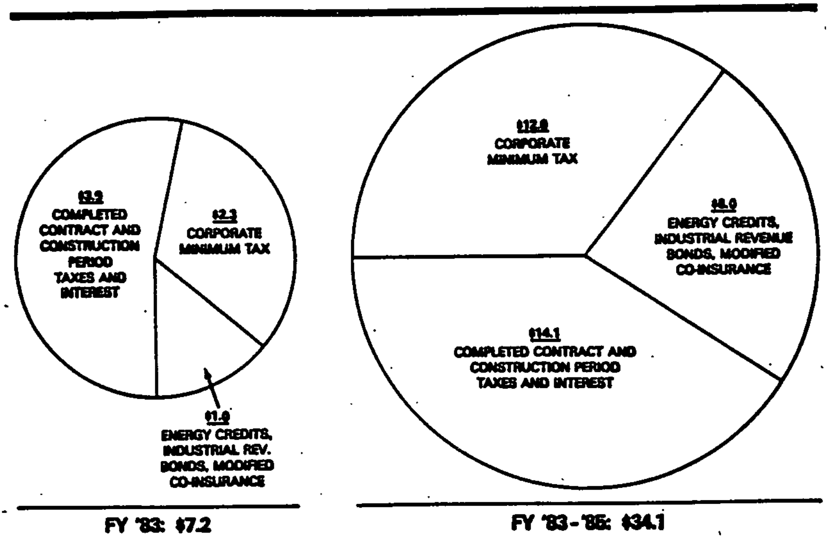


FY '83: $20.3

FY '83 - '85: $68.2

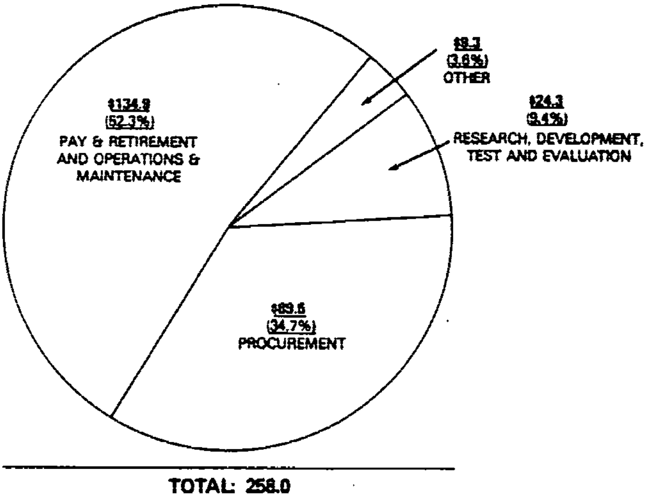
The next chart shows the tax changes. As indicated on the chart, we expect $7.2 billion in additional revenues from these proposals in FY 1983.

TAX REVISIONS
(BILLIONS OF DOLLARS)



The next chart covers the Fiscal Year 1983 defense program, and highlights what I believe to be a common misunderstanding about the composition of the defense program.

COMPOSITION OF FY '83 DEFENSE PROGRAM



Over half of the defense budget is accounted for by pay, by retirement and by basic operations and maintenance we can't do without. Only about a third involves procurement of the major weapons and communications systems needed as part of adequate defense restoration.

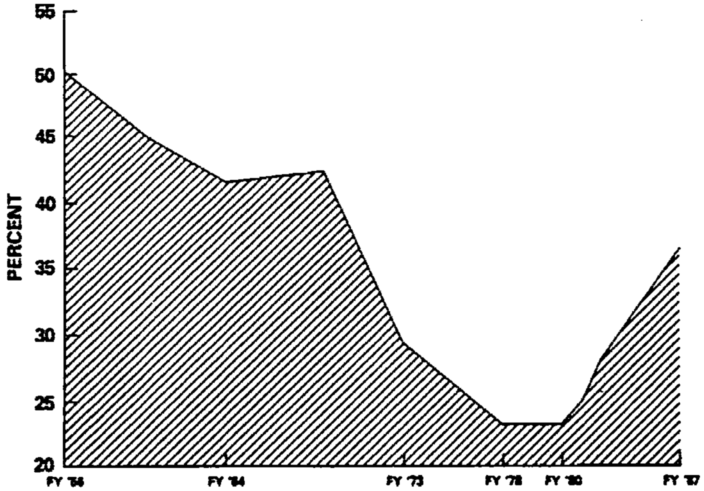
It is important to note that these procurement programs spend out very slowly. It takes years to build a ship. It takes years to deliver an order of planes or tanks or other major defense hardware. As a result, the outlay impact of the defense restoration that we have underway is relatively modest in the current year and in the near term in the 1983 and 1984 budgets.

The real budgetary impact in terms of cash outlays that we must finance does not occur until farther down the road. These occur in '85 and especially '86 and '87 period.

I think another background point that is important to make here is that we _are_ in fact substantially shifting the composition of the budget, the internal priorities. The defense share of the entire budget will be rising steadily this year and in future years.

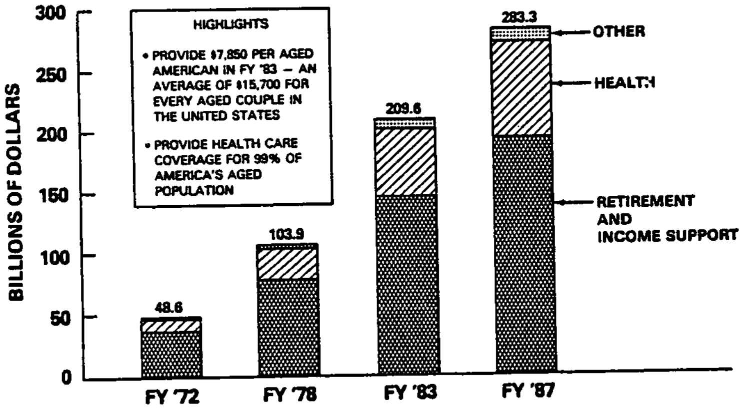
If set in historical perspective, however, you will see that even as we complete the buildup by '86 or '87, the defense share of the entire budget will be significantly smaller than it was for most of the 25 or 30 years period before 1973, when the decline of defense spending and the problem of underinvestment and neglect got underway.

DEFENSE SHARE OF BUDGET



I would like to call your attention to a couple of final charts that show what we are funding in the budget of $758 billion in outlays. After all, most of the attention, and properly so, has been given to the reductions and savings that we have proposed.

FEDERAL OUTLAYS BENEFITING THE ELDERLY

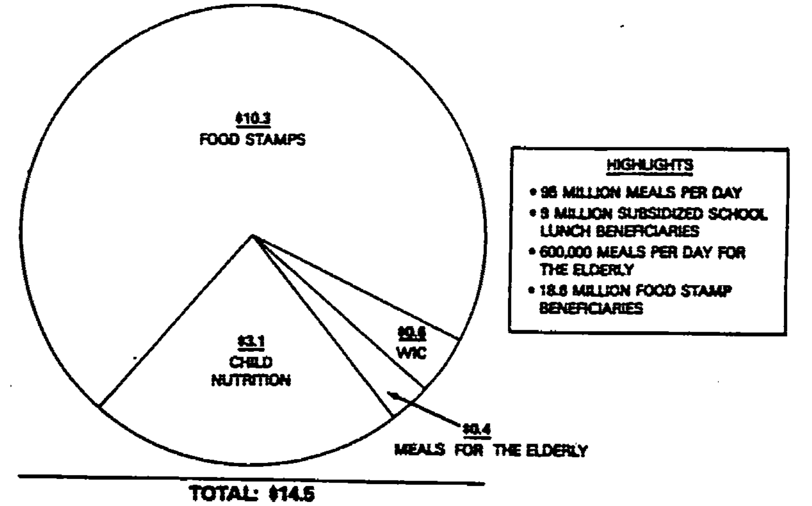


The major category we are funding is a steadily increasing level of outlays to support the elderly population, for a whole variety of purposes. These are building on Social Security and the retirement support system, moving into Medicare, and then include a variety of other programs that predominantly and significantly benefit the elderly, including a good part of Medicaid, a significant part of the Food Stamp program, and all of the various older American service programs.

The chart highlights the $15 billion increase in total outlays in the programs that directly benefit the elderly in '83 over 1982, a doubling of the levels just since 1978. All expenditures for all of those programs affecting the aged amount to about $15,700 for each elderly couple in the United States

FEDERAL OUTLAYS FOR NUTRITION — FY '83

(BILLIONS OF DOLLARS)



There will be considerable controversy about some of the changes we are proposing in nutrition and in the Food Stamp program. But, I think it is important to assess those changes and their merits in the context of the entire effort and financial commitment of the Federal Government to nutrition in this budget, even after the proposed changes.

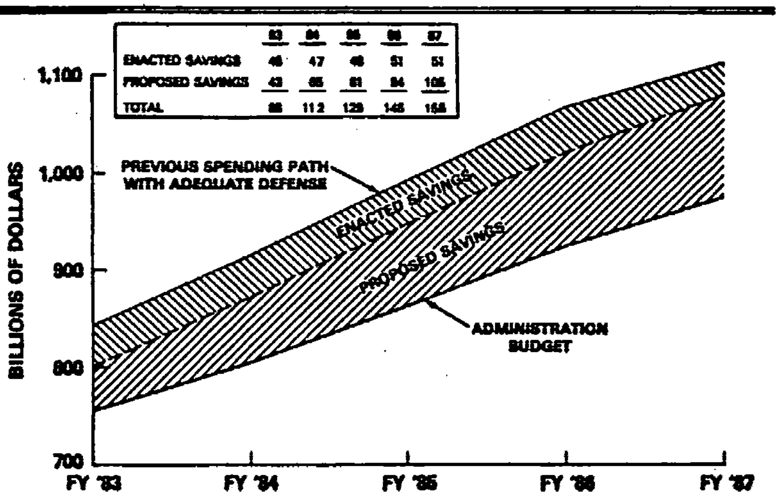
There will still be $14.5 billion committed in this budget to the main federal nutrition programs. We will still provide and finance more than 95 million meals per day for those who need nutritional assistance from the Federal Government.

It includes almost 19 million food stamp beneficiaries, nearly 9 million students in the elementary and secondary schools who receive subsidized or free lunches, and more than 600,000 meals per day for the elderly through the Older Americans Act Program.

While we are making continuing efforts to refocus and to target programs and to eliminate abuses or excesses in some of the entitlement programs that are means tested or designed for the lower income population, the total financial commitment to those who need support from the government continues to rise in the '83 budget and in future budgets. This substantially exceeds the commitments that we made in the very recent past.

The next chart is designed to give some indication of what all of this adds up to. It shows both the large changes on the tax and outlay sides that we made last year, as well as the further changes that we are proposing this year.

POLICY CHANGE — SPENDING TREND

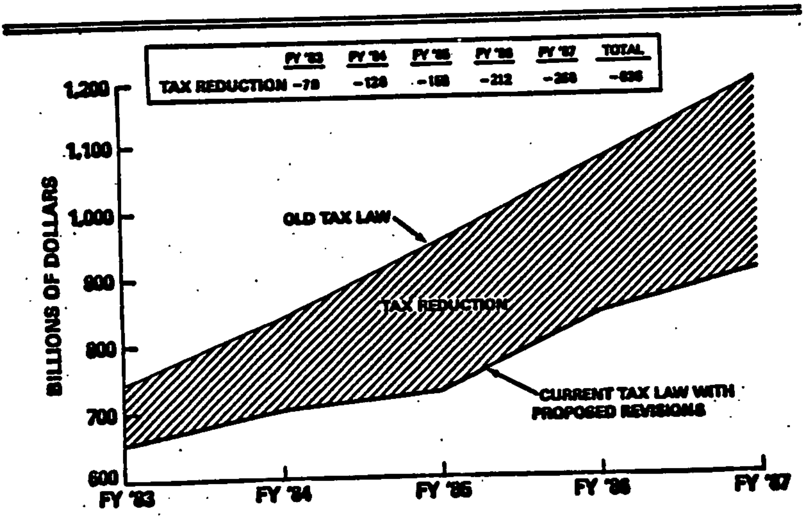


The next chart racks up the enacted savings that were achieved in reconciliation last year, together with the savings achieved in the appropriations process. It also shows the proposed savings that we have in the budget. And as you can see, relative to the built-in base of spending that we inherited in January 1981, we have rather dramatically and rather substantially shifted in a downward direction the growth path of the budget.

In 1983 alone, spending will be $88 billion lower, with the proposed and enacted savings, than it would have been under the previous spending path. These savings rise steadily above $112 billion in '84 and to about $156 billion by '87.

Added together, the total of these initiatives would amount to $630 billion outlay savings over the five years that are in this budget.

POLICY CHANGE — TAX REVENUES

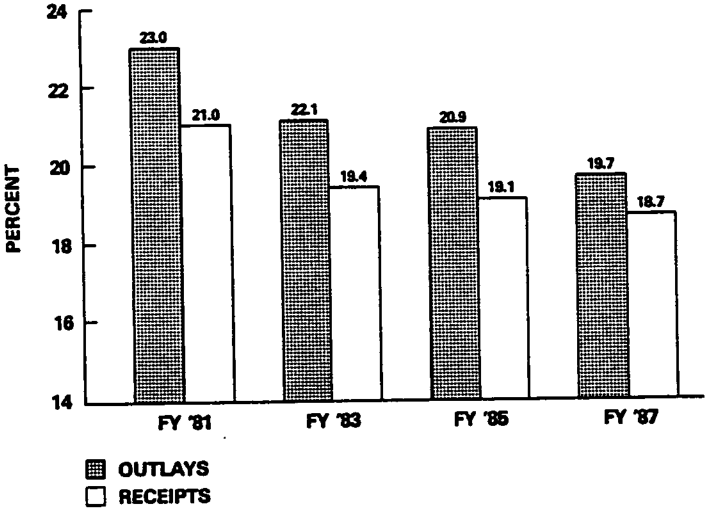


The next chart indicates, at least on a static basis, the revenue loss as a result of the tax program last year. The charge was constantly made, which I believe is erroneous and was never consistent with the basic fiscal plan we had, that the losses on the revenue side drastically dwarfed any changes in savings we were getting on the outlay side. We indicated last year that the process of reducing the budget outlays was not a one-year proposition but a continuing effort, that we would provide at least $30 billion more in savings in '83 and $44 billion more in '84.

We have offered substantially more savings than that in the 1983 budget. The total outlay savings between the '82 proposals enacted last year and what we are projecting for this year bring the revenue reductions and the outlay reductions over time into a much closer balance.

The bottom line of all of this is where the budget as a whole is heading relative to the rest of the economy, to the rest of the governmental system, and to the rest of our society. That is the touchstone of the entire program that the President proposed last year to shrink the Federal spending share of GNP. With this year's budget proposal the outlay share shrinks and the tax share continues to decline as we move to each passing year in the projection period.

POLICY CHANGE — FEDERAL SHARE OF GNP



This concludes my prepared statement, Mr. Chairman. I would welcome any questions that Members of the Committee may have about the President's budget proposals.

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PRESENTATION OF

HONORABLE DAVID A. STOCKMAN

DIRECTOR, OFFICE OF MANAGEMENT AND BUDGET

BEFORE THE JOINT ECONOMIC COMMITTEE

FEBRUARY 10, 1982

THE FY83 BUDGET TOTALS

- OUTLAYS INCREASE BY $32 BILLION TO $758 BILLION -- THE SMALLEST INCREASE SINCE FY 74.
- REVENUES INCREASE BY $39 BILLION TO $666 BILLION -- REFLECTING THE RECOVERY OF BUSINESS ACTIVITY AND EMPLOYMENT AFTER MID-1982.
- THE DEFICIT AT $92 BILLION REMAINS HIGH -- BUT IS SUBSTANTIALLY SMALLER RELATIVE TO GNP THAN THE COMPARABLE RECOVERY YEAR OF FY 76 (2.7% VS. 4.0%).

THE BUDGET AT A GLANCE

(BILLIONS OF DOLLARS)

ITEM	FY '82 ESTIMATE	FY '83 ESTIMATE	FY '84 ESTIMATE	FY '85 ESTIMATE
RECEIPTS	627	666	723	797
OUTLAYS	725	758	806	868
DEFICIT	−99	−92	−83	−72

DRAMATIC DECLINE IN SPENDING GROWTH RATE

- THE RUNAWAY SPENDING MOMENTUM OF FY 77-81 HAS BEEN DECISIVELY REVERSED -- THE BUDGET IS BEING BROUGHT UNDER CONTROL.

- THE PROPOSED 4.5% INCREASE FOR FY 83 IS ONE-HALF THE FY 82 RECESSION BUDGET GROWTH AND ONE-FOURTH THE FY 80 PEAK SPENDING GROWTH.

- THE FY 83 INCREASE IS THE LOWEST ANNUAL BUDGET GROWTH SINCE FY 69.

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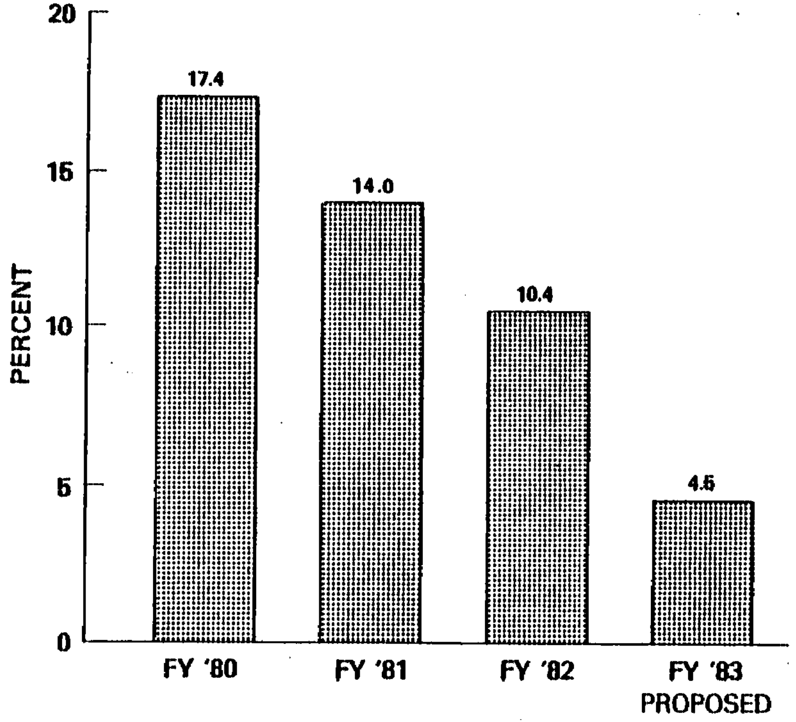
DRAMATIC DECLINE IN SPENDING GROWTH
1980–83



FIVE-PART BUDGET SAVINGS PLAN

- WITHOUT AN AGGRESSIVE AND COMPREHENSIVE BUDGET SAVINGS PLAN, THE DEFICIT WOULD RISE TO THE $150 BILLION RANGE DURING FY 83-85.
- THE PRESIDENT'S FY 83 BUDGET PROPOSES ACROSS-THE-BOARD MEASURES TO REDUCE THE DEFICIT -- WITH SAVINGS OF $56 BILLION IN FY 83 AND $239 BILLION OVER THE NEXT THREE YEARS.
- THESE BUDGET SAVINGS MEASURES REDUCE THE PROSPECTIVE THREE-YEAR DEFICIT TOTAL BY 50%.

FIVE-PART BUDGET SAVINGS PLAN

(BILLIONS OF DOLLARS)

	FY '83	FY '84	FY '85
DEFICIT WITHOUT SAVINGS PLAN	−147	−167	−171
FIVE-PART DEFICIT REDUCTION PLAN	+56	+84	+99
PROPOSED DEFICIT WITH REDUCTION PLAN	−92	−83	−72

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FIVE-PART BUDGET SAVINGS PLAN -- FY 83

A COMPREHENSIVE AND BALANCED PLAN -- PROVIDES $56 BILLION IN SAVINGS IN ALL AREAS OF THE BUDGET WHERE REFORMS, CUTBACKS AND OTHER CONTRIBUTIONS TO CLOSING THE DEFICIT GAP ARE POSSIBLE.

1. MANAGEMENT SAVINGS OF $20.3 BILLION INCLUDE INTENSIFIED DEBT COLLECTION, SURPLUS PROPERTY DISPOSAL, ACCELERATED OFF-SHORE LEASING, STRENGTHENED IRS REVENUE COLLECTION PROGRAMS, AND FEDERAL PAY RESTRAINT.

2. ENTITLEMENT REFORM SAVINGS OF $11.7 BILLION INCLUDE MEDICAL COST LIMITS, FOOD STAMP REFORMS AND FEDERAL RETIREMENT COLA CAPS,

3. DISCRETIONARY PROGRAM SAVINGS OF $14.2 BILLION INCLUDE NEW PROGRAM CONSOLIDATIONS IN MANPOWER AND NUTRITION, REDUCTIONS IN ENERGY, EDUCATION AND BUSINESS SUBSIDIES, AND TIGHT SPENDING LIMITS FOR MOST OTHER PROGRAMS.

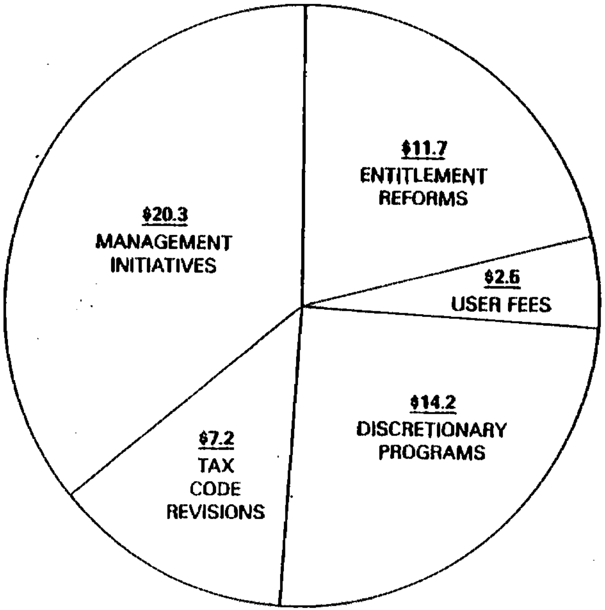
4. TAX REVISIONS OF $7.2 BILLION INCLUDE A STRENGTHENED CORPORATE MINIMUM TAX AND ELIMINATION OF OBSOLETE TAX INCENTIVES.

5. USER FEE SAVINGS OF $2.5 BILLION INCLUDE COST RECOVERY FROM AVIATION, NUCLEAR, MARITIME AND OTHER INDUSTRIES.

FIVE-PART BUDGET SAVINGS PLAN

— FY '83 —

(BILLIONS OF DOLLARS)



TOTAL: $55.9

DEFICIT SHARE OF GNP IN RECESSION/RECOVERY CYCLES

- WHILE LARGE IN ABSOLUTE TERMS, THE PROJECTED FY 82-85 DEFICITS ARE ACTUALLY SMALLER AS A SHARE OF GNP THAN THOSE RECORDED DURING THE FY 75-78 RECESSION AND RECOVERY CYCLE.

- MOREOVER, THEY STEM FROM A WHOLLY DIFFERENT SOURCE, WITH SUBSTANTIALLY DIFFERENT IMPLICATIONS FOR FUTURE FISCAL POLICY AND FINANCIAL MARKETS:

  - THE FY 75-78 DEFICITS WERE DRIVEN BY A RAPID ACCELERATION OF SPENDING GROWTH AND NEW BUDGET COMMITMENTS. TOTAL SPENDING AFTER INFLATION GREW AT A 3.8% ANNUAL RATE. NON-DEFENSE SPENDING GREW AT A 5.2% REAL RATE.

  - THE FY 82-85 DEFICITS ARE DRIVEN PRIMARILY BY ADJUSTMENTS IN THE ECONOMY TO THE STEADY REDUCTION OF INFLATION AND BY THE SLOW PROCESS OF PARING-BACK PAST SPENDING COMMITMENTS.

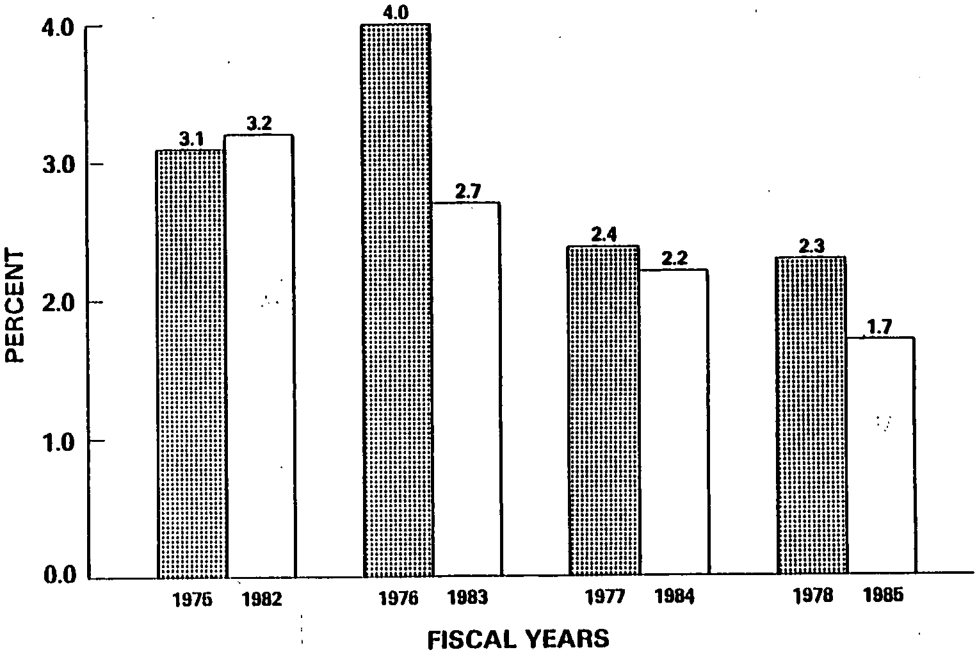
  - IN CONTRAST TO FY 75-78, THE REAL SPENDING GROWTH RATE WILL AVERAGE ONLY 0.4% OVER FY 82-85. NON-DEFENSE SPENDING WILL DECLINE AT A 2.6% REAL RATE.

<u>DEFICIT SHARE OF GNP IN RECESSION/RECOVERY CYCLES</u>
(CONTINUED)

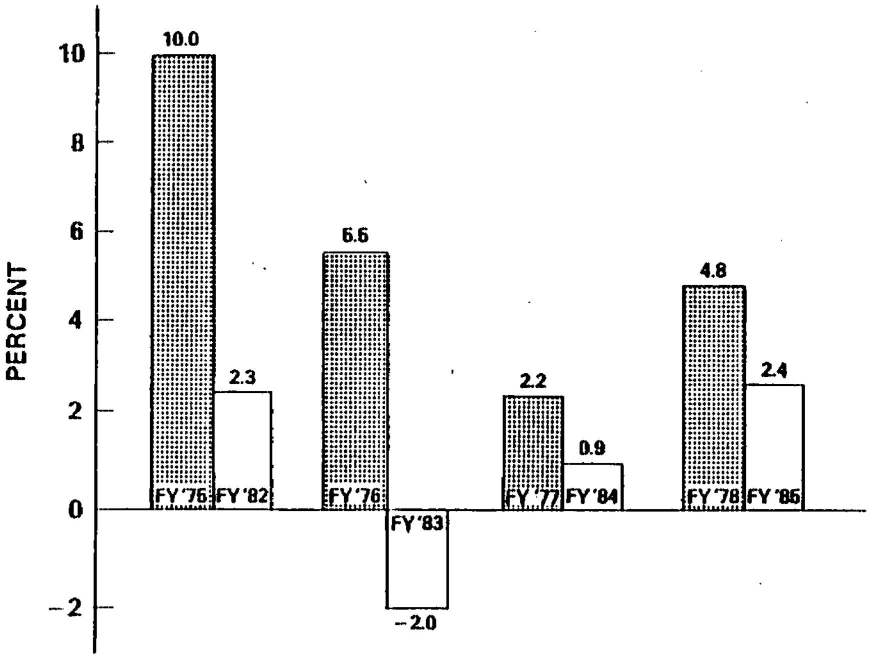
o THE FY 82-85 DEFICITS, THEN, ARISE FROM AN ENVIRONMENT -- ECONOMIC RECOVERY, DISINFLATION AND SHRINKAGE OF FUTURE BUDGET COMMITMENTS -- IN WHICH THE OUTLAY AND REVENUE PATHS WILL <u>CONVERGE</u> OVER TIME -- RATHER THAN <u>DIVERGE</u> AS IN FY 75-78.

DEFICITS AS A SHARE OF GNP IN RECESSION/RECOVERY CYCLES

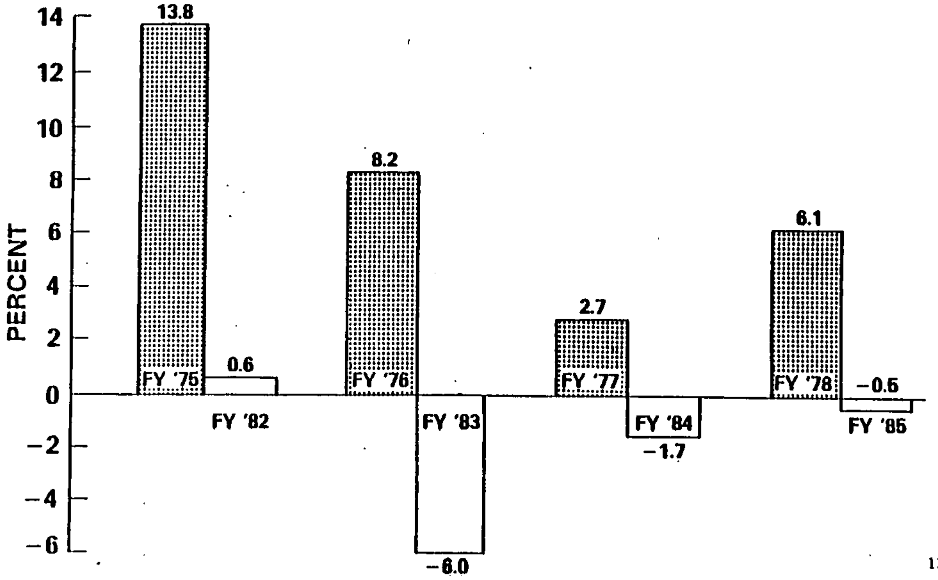
(1975-78 VS. 1982-85)



REAL SPENDING GROWTH RATES
FY '75-78 VS. FY '82-85



DIFFERENCE IN NON-DEFENSE REAL SPENDING GROWTH RATES 1975–78 VS. 1982–85



IMPACT OF CHANGE IN THE ECONOMIC OUTLOOK ON THE BUDGET PROJECTIONS

- THE LARGE DEFICITS CURRENTLY PROJECTED COMPARED TO THE ORIGINAL ADMINISTRATION ESTIMATES ARE ENTIRELY DUE TO CHANGES IN THE ECONOMIC OUTLOOK AND TO THE BUDGETARY IMPACTS OF THE ECONOMY'S TRANSITION TO A PATH OF LOW INFLATION, SUSTAINED REAL GROWTH AND FINANCIAL EQUILIBRIUM.

- IN COMBINATION, THE RECESSION AND MORE RAPID THAN ANTICIPATED FALL OF INFLATION WILL SUBSTANTIALLY REDUCE FUTURE NOMINAL GNP LEVELS. COMPARED TO THE ADMINISTRATION'S ORIGINAL FORECAST, NOMINAL GNP WILL BE $176 BILLION LOWER IN 1983 AND $267 BILLION LOWER BY 1986. THIS SUBSTANTIAL DOWNSHIFT OF PROJECTED GNP LEVELS AND FUTURE INFLATION RATES DRAMATICALLY LOWERS RECEIPT PROJECTIONS.

- AT THE SAME TIME, THE FINANCIAL ADJUSTMENTS TO A STEADY SLOWING OF MONEY GROWTH AND INFLATION RATES WILL RESULT IN A SLOWER DECLINE IN INTEREST RATES THAN ORIGINALLY PROJECTED. THIS WILL ADD SUBSTANTIALLY TO DEBT SERVICE COST FOR SEVERAL YEARS.

- ALSO, THE OUTLAY SAVINGS FROM LOWER COLA ADJUSTMENTS LAG BEHIND THE FALL OF INFLATION BECAUSE THEY ARE DETERMINED BY A BASE PERIOD STARTING 18 MONTHS BEFORE THE FISCAL YEAR.

IMPACT OF CHANGE IN THE ECONOMIC OUTLOOK ON THE BUDGET PROJECTIONS
(CONTINUED)

- THE PROCESS OF DISINFLATION, THEN, CREATES A TEMPORARY FISCAL PREDICAMENT IN WHICH RECEIPTS GROWTH SLOWS IMMEDIATELY IN RESPONSE TO LOWER INFLATION COMPONENTS IN TAXABLE INCOMES, WHILE THE OUTLAY GROWTH RESPONSE IS DELAYED BY HIGH DEBT SERVICE COSTS, THE LAG IN COLA ADJUSTMENTS AND OTHER SOURCES OF CARRY-OVER SPENDING MOMENTUM.

- THESE CHANGES FROM THE ORIGINAL FORECAST INCREASE FY 83 OUTLAYS BY $31 BILLION BECAUSE OF HIGHER INTEREST. THEY ALSO REDUCE RECEIPTS BY $51 BILLION -- SHIFTING THE BUDGET FROM A NEAR BALANCE TO $92 BILLION DEFICIT.

- DEFICITS BEYOND FY 83 ARE ENTIRELY ATTRIBUTABLE TO THESE CHANGES IN THE ECONOMIC OUTLOOK -- RATHER THAN POLICY SHORTCOMINGS.

- IN FACT, THE FY 83 BUDGET PROVIDES MORE THAN THE $30 BILLION AND $44 BILLION IN FUTURE BUDGET SAVINGS FOR 83 AND 84 SLATED IN THE ORIGINAL ADMINISTRATION BUDGET PLAN.

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IMPACT OF CHANGE IN ECONOMIC OUTLOOK ON DEFICIT PROJECTION

(BILLIONS OF DOLLARS)

	FY '82	FY '83	FY '84	FY '86
CURRENT DEFICIT ESTIMATE	−99	−92	−83	−72
DEFICIT ESTIMATE WITH ORIGINAL ECONOMIC ASSUMPTIONS	−42	−2	+8	+21
SOURCE OF CHANGE:				
HIGHER INTEREST AND DEBT	17	31	36	40
LOWER NOMINAL GNP & INFLATION	32	51	51	51
HIGHER UNEMPLOYMENT	8	8	4	2

FIVE-PART BUDGET SAVINGS PLAN
— FY '83-85 —
(BILLIONS OF DOLLARS)

	FY '83	FY '84	FY '85	TOTAL	SHARE
ENTITLEMENT REFORMS	11.7	17.1	22.8	51.6	22%
USER FEES	2.5	3.5	3.8	9.8	4%
DISCRETIONARY PROGRAM CUTS	14.2	26.1	35.3	75.6	32%
MANAGEMENT INITIATIVES	20.3	24.0	23.9	68.2	28%
TAX REVISIONS	7.2	13.5	13.5	34.1	14%
TOTAL	55.9	84.1	99.3	239.3	100%

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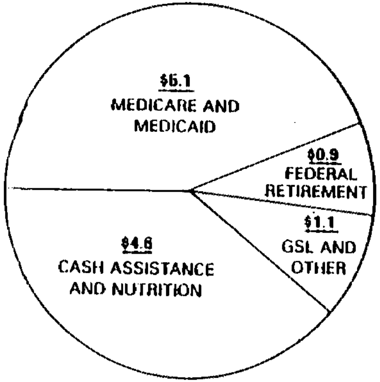
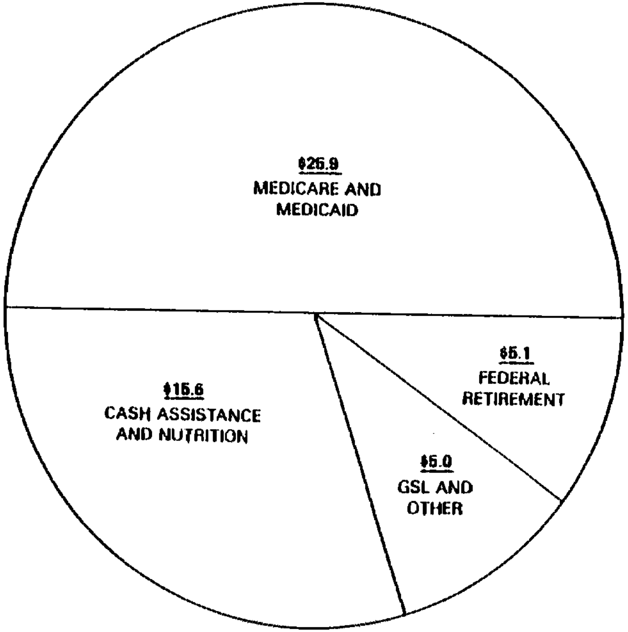
ENTITLEMENT REFORMS

(BILLIONS OF DOLLARS)



FY '83: $11.7



FY '83-85: $51.6

KEY ENTITLEMENT REFORMS

MEDICAL CARE

- PROVIDER REIMBURSEMENT SAVINGS
- CO-PAYMENTS AND INDEXING OF DEDUCTIBLE
- FEDERAL EMPLOYEE COVERAGE -- HI TAX
- PRO-COMPETITION COST CONTAINMENT PLAN -- LATER TRANSMITTAL

CASH ASSISTANCE

- SSI -- MEDICAL DISABILITY AND 24 MONTH PROGNOSIS
- AFDC -- TIGHTEN WORKFARE, BROADEN INCOME TESTS

FEDERAL RETIREMENT

- LOWER OF FEDERAL PAY RAISE OR CPI
- LIMIT COLA TO LESS THAN CPI WHERE ANNUITIES EXCEED CURRENT RETIREMENT LEVELS

KEY ENTITLEMENT REFORMS
(CONTINUED)

FOOD STAMPS AND NUTRITION

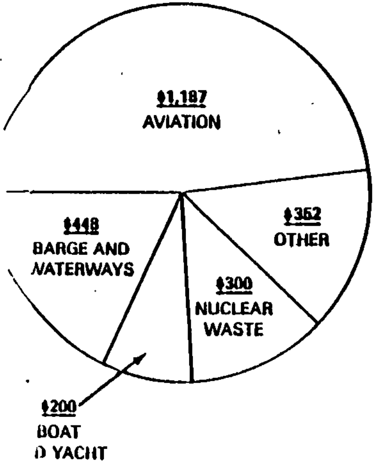
- RAISE INCOME CONTRIBUTION FOR FOOD FROM 30% TO 35%
- ELIMINATE EARNED INCOME DISREGARD
- BENEFIT ROUNDING, MANDATORY JOB SEARCH
- ELIMINATE SPECIAL MILK AND SUMMER FEEDING

GUARANTEED STUDENT LOANS

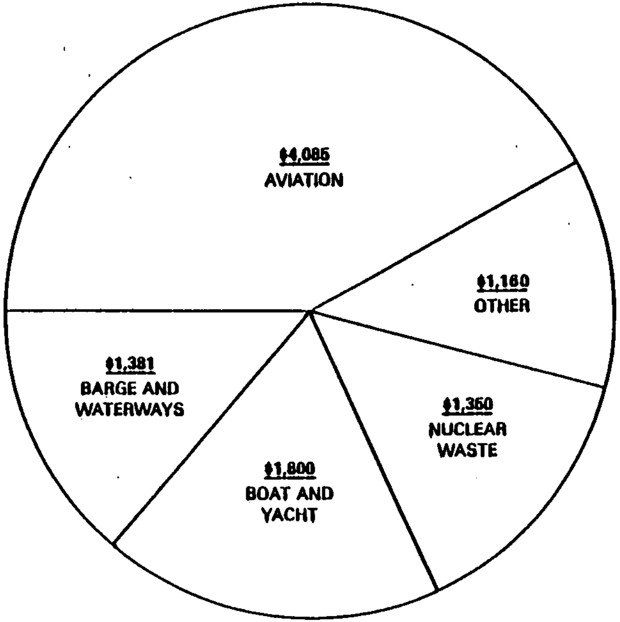
- RAISE ORIGINATION FEE FROM 5% TO 10%
- TIGHTEN AND APPLY NEEDS TEST TO ALL APPLICANTS
- ELIMINATE FULL INTEREST SUBSIDY FOR GRADUATE STUDENTS

USER FEES

(MILLIONS OF DOLLARS)



FY '83: $2,487



FY '83-'85: $9,776

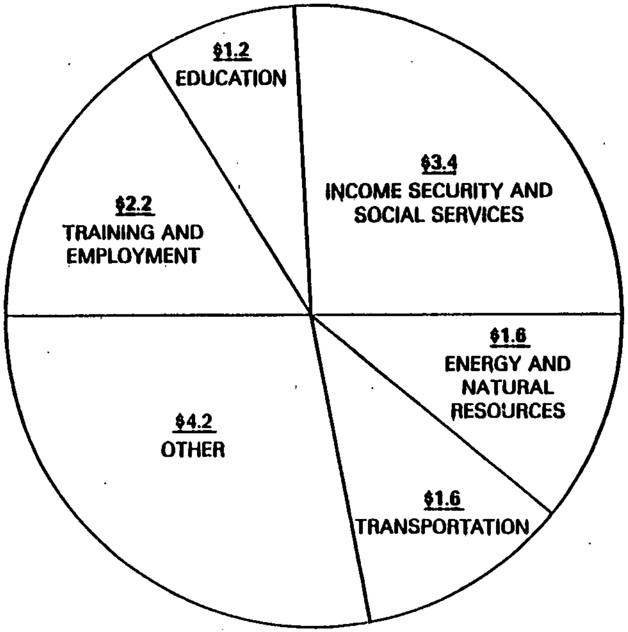
USER FEE INITIATIVE

FIFTEEN NEW, INCREASED OR RE-PROPOSED USER FEES WOULD YIELD $2.5 BILLION IN FY 83 RISING TO $3.8 BILLION BY FY 85

- AVIATION USER FEES TO RECOVER 85% OF AIR TRAFFIC CONTROL SYSTEM COSTS FINANCED WITH 8% PASSENGER TICKET TAX AND INCREASED GENERAL AVIATION GASOLINE AND JET FUEL TAXES
- CORPS OF ENGINEERS NAVIGATION FEES TO RECOVER NEW CONSTRUCTION AND MAINTENANCE EXPENSES FOR COMMERCIAL PROJECTS
- COMMERCIAL NUCLEAR WASTE DISPOSAL TO ESTABLISH AN INDEPENDENT AND SELF-FINANCING WASTE DISPOSAL OPERATION -- $300 MILLION IN INITIAL YEAR
- COAST GUARD USER FEES FOR LICENSES, INSPECTIONS, NAVIGATION AIDS AND SEARCH AND RESCUE MISSIONS
- RECREATION FEES FOR PARK ENTRY AND USE OF FACILITIES
- PATENTS AND TRADEMARK FEES TO COVER APPLICATION PROCESSING COSTS AND TO OFFSET THE COSTS OF PATENT AND TRADEMARK OFFICE (PTO).

DISCRETIONARY PROGRAMS

(BILLIONS OF DOLLARS)



TOTAL: $14.2

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HIGHLIGHTS OF DISCRETIONARY PROGRAM SAVINGS

EDUCATION, EMPLOYMENT AND TRAINING

- o CONSOLIDATION OF EMPLOYMENT AND TRAINING PROGRAMS INTO BLOCK GRANT -- $1.9 BILLION SAVINGS
- o TARGET PELL GRANTS TO LOWER INCOME STUDENTS
- o REDUCE CAMPUS BASED AID PROGRAMS -- FOCUSE ON WORK-STUDY
- o IMPACT AID -- LIMIT PAYMENTS TO "A" STUDENTS ONLY
- o ELEMENTARY AND SECONDARY EDUCATION -- REDUCE GRANTS BY $1.8 BILLION
- o VOCATIONAL EDUCATION AND REHABILITATION -- REDUCE GRANTS BY ONE-THIRD

HOUSING

- o ELIMINATE NEW SECTION 8 STARTS EXCEPT FOR 10,000 ELDERLY UNITS AND REPLACE WITH LESS EXPENSIVE CERTIFICATES -- 107,000 IN FY 83
- o 30% RENT BURDEN FOR NEW TENANTS; COUNT FOOD STAMP INCOME, ELIMINATE NEGATIVE RENT PAYMENT

HIGHLIGHTS OF DISCRETIONARY PROGRAM SAVINGS

(CONTINUED)

INCOME SECURITY, SOCIAL SERVICES

- o CONSOLIDATE WIC WITH MCH
- o RE-TARGET LOW-INCOME ENERGY AID TO COLDER STATES
- o REDUCE TITLE XX GRANTS BY 18%
- o CHILD WELFARE BLOCK GRANT
- o NO FUNDING FOR LEGAL SERVICES

TRANSPORTATION

- o REDUCE FUNDING FOR NON-INTERSTATE HIGHWAYS BY 21%
- o REDUCE MASS TRANSIT OPERATING SUBSIDIES BY 38%
- o REDUCE AMTRAK BY $185 MILLION -- INCREASED COST ABSORPTION BY LABOR, PASSENGERS, LOCALITIES

HIGHLIGHTS OF DISCRETIONARY PROGRAM SAVINGS

(CONTINUED)

ENERGY AND NATURAL RESOURCES

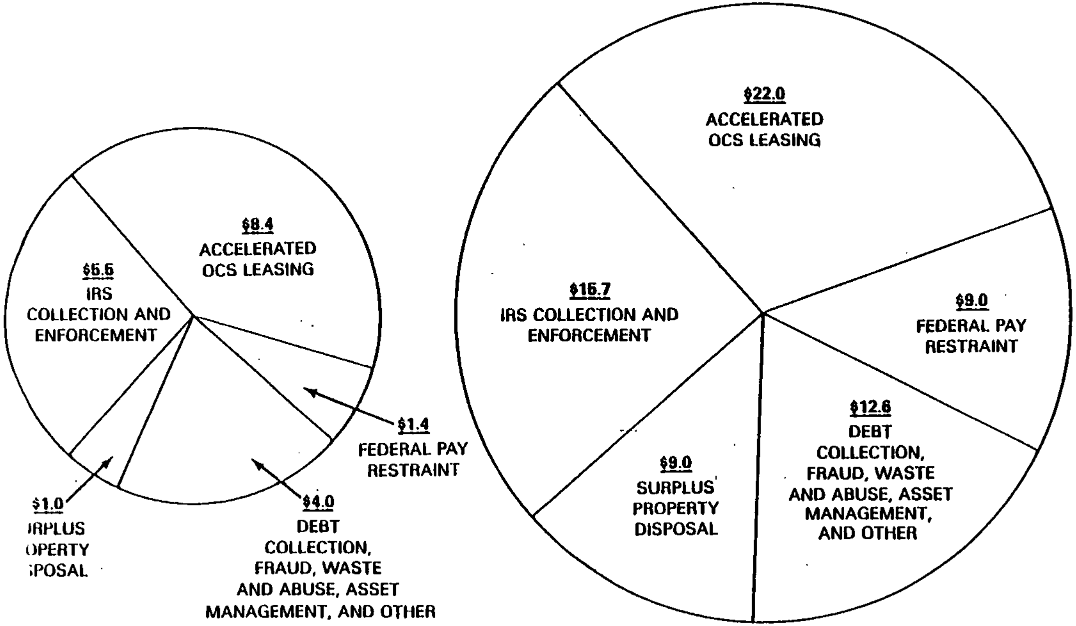
- ELIMINATE REMAINING NON-NUCLEAR DEVELOPMENT, DEMONSTRATION AND COMMERCIALIZATION FUNDING -- SAVE $900 MILLION
- TERMINATE STATE CONSERVATION AND LOW-INCOME WEATHERIZATION
- CUT SOIL CONSERVATION GRANTS 33%

BUSINESS SUBSIDIES

- EXPORT-IMPORT BANK DIRECT LOANS 18% BELOW CURRENT SERVICES
- NO NEW MARITIME CONSTRUCTION OR OPERATING SUBSIDY CONTRACTS

MANAGEMENT INITIATIVES

(BILLIONS OF DOLLARS)



FY '83: $20.3

FY '83-'85: $68.2

MANAGEMENT INITIATIVES

IRS COLLECTION AND ENFORCEMENT

- 5200 ADDITIONAL IRS STAFF TO REDUCE DELINQUENT ACCOUNT BACKLOG, INCREASE AUDIT COVERAGE OF LARGE COMPANIES, AND IDENTIFY NON-FILERS
- WITHHOLDING OF TAXES ON INTEREST AND DIVIDENDS
- ACCELERATION OF CORPORATE TAX COLLECTION TO 90% OF ESTIMATED LIABILITY

FEDERAL PAY RESTRAINT

- LIMIT PAY RAISE TO 5%

ACCELERATED OFF-SHORE LEASING

- THE ADMINISTRATION'S ACCELERATED OCS LEASING PROGRAM IS EXPECTED TO RESULT IN AN AVERAGE OF 5.7 MILLION ACRES PER YEAR IN SALES, WHICH IS MORE THAN DOUBLE THE AVERAGE UNDER THE CARTER SCHEDULE
- WILL RESULT IN INCREASED BONUS PAYMENTS THAT NEARLY DOUBLE PROJECTED RECEIPTS FROM OCS BONUS AND ROYALTY PAYMENTS TO A TOTAL OF $18 BILLION IN FY 83

MANAGEMENT INITIATIVES
(CONTINUED)

SURPLUS PROPERTY DISPOSAL

- SURPLUS GSA PROPERTY TRANSFERRED TO OTHER AGENCIES ONLY AT MARKET VALUE, NOT FREE AS CURRENT PRACTICE
- HIGH-LEVEL PROPERTY REVIEW BOARD TO OVERSEE REAL PROPERTY MANAGEMENT, IDENTIFICATION OF UNNEEDED HOLDINGS AND SPEEDY DISPOSAL WHEREVER POSSIBLE
- DISPOSE OF TENS OF MILLIONS OF ACRES OF PUBLIC LAND WITH NO UNIQUE WILDERNESS, RECREATIONAL OR HISTORIC SIGNIFICANCE, INCLUDING PARCELS ADJACENT TO NEWLY URBANIZED AREAS, AND SMALL, ISOLATED TRACTS TOO COSTLY TO MANAGE

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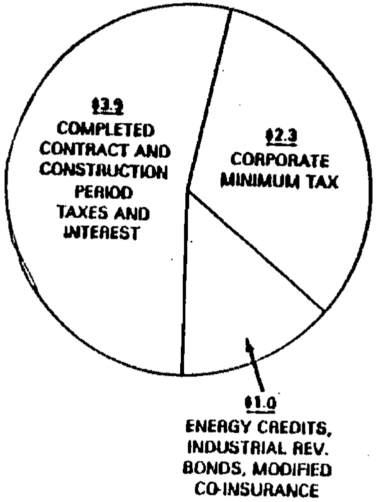
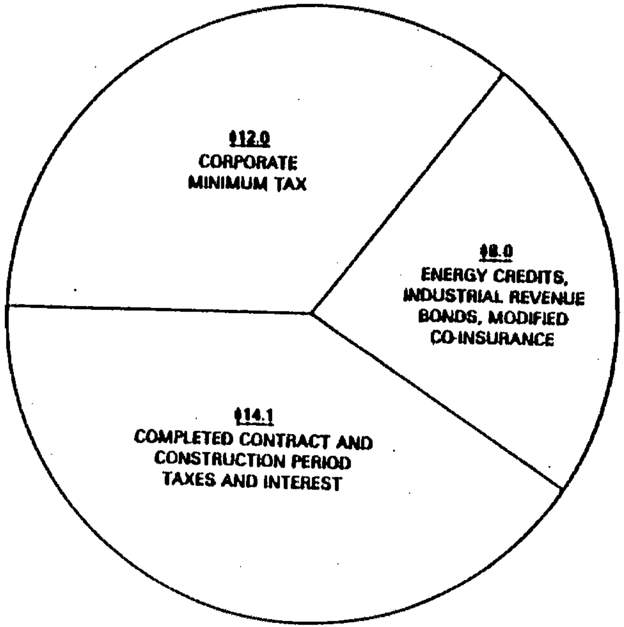
DEBT COLLECTION

- 24 AGENCIES WILL HAVE COMPREHENSIVE COLLECTION PLANS AND TARGETS -- INCLUDING INCREASED TRAINING, ACCOUNTABILITY AND IMPROVED TECHNIQUES
- NEW LEGISLATIVE AUTHORITY INCLUDING FURNISHING OF SOCIAL SECURITY NUMBERS, BROADER AUTHORITY TO CONTRACT OUT, POWER TO ASSESS INTEREST AND PENALTIES ON OVERDUE ACCOUNTS AND TO REFER INFORMATION ON DELINQUENT DEBTORS TO CREDIT BUREAUS

TAX REVISIONS
(BILLIONS OF DOLLARS)



FY '83: $7.2



FY '83 - '85: $34.1

TAX REVISIONS

CHANGES ARE DESIGNED TO ELIMINATE ABUSES, REMOVE OBSOLETE INCENTIVES, CORRECT UNINTENDED LOOPHOLES, AND REQUIRE PROFITABLE BUSINESS TO CONTRIBUTE AT LEAST SOME MINIMUM FAIR SHARE.

- DISALLOW COMPLETED CONTRACT METHOD OF TAX ACCOUNTING. TAXPAYERS WILL BE REQUIRED TO USE EITHER THE PERCENTAGE OF COMPLETION METHOD OR THE PROGRESSIVE PAYMENT METHOD OF ACCOUNTING FOR LONG-TERM CONTRACTS.

- REPEAL ALL BUSINESS ENERGY TAX SUBSIDIES AND SPECIAL PROVISIONS ALLOWING STATES AND LOCALITIES TO ISSUE TAX-EXEMPT INDUSTRIAL DEVELOPMENT BONDS TO FINANCE CERTAIN ENERGY PROJECTS.

- ASSETS FINANCED WITH TAX-EXEMPT REVENUE BONDS ISSUED AFTER 1982 MUST BE DEPRECIATED USING THE STRAIGHT LINE METHOD. TAX-EXEMPT REVENUE BOND FINANCING WILL BE LIMITED TO BONDS THAT ARE PUBLICLY APPROVED AND AFTER 1985, RECEIVE A FINANCIAL COMMITMENT FROM THE LOCAL GOVERNMENT. SMALL ISSUE INDUSTRIAL DEVELOPMENT BONDS WILL NOT BE ALLOWED FOR LARGE BUSINESSES.

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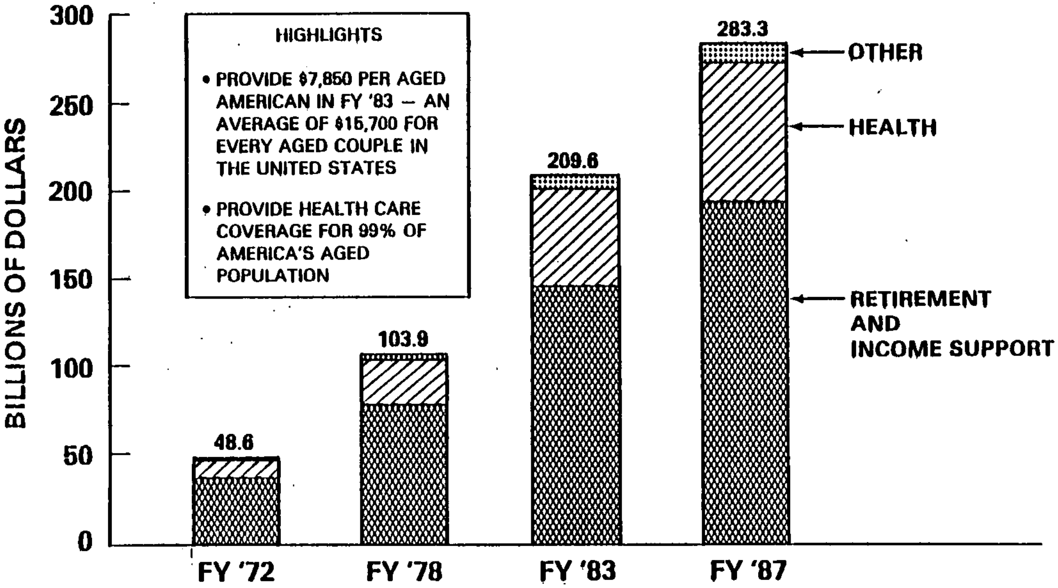
TAX REVISIONS
(CONTINUED)

- REPEAL UNINTENDED WINDFALL FROM MODIFIED CO-INSURANCE TAX ACCOUNTING ROLES.

- AMORTIZE CONSTRUCTION PERIOD INTEREST AND TAXES INCURRED BY CORPORATIONS TO DEVELOP NON-RESIDENTIAL REAL PROPERTY. COSTS WILL BE RECOVERED OVER TEN YEARS.

- TO THE ADD-ON MINIMUM TAX WILL BE REPLACED WITH A 15% ALTERNATIVE MINIMUM TAX THAT WOULD APPLY ONLY TO THOSE CORPORATIONS THAT PAY VERY LOW REGULAR TAX RATES.

FEDERAL OUTLAYS BENEFITING THE ELDERLY



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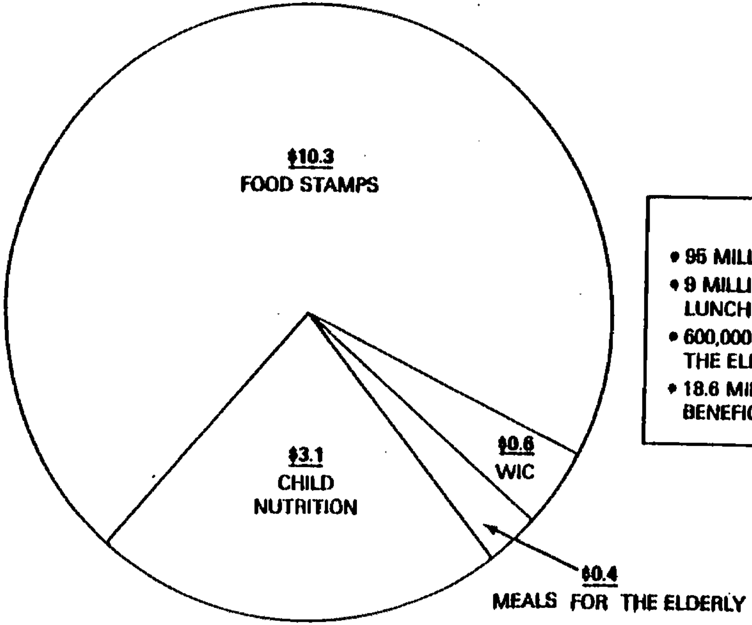
FEDERAL OUTLAYS FOR NUTRITION — FY '83

(BILLIONS OF DOLLARS)

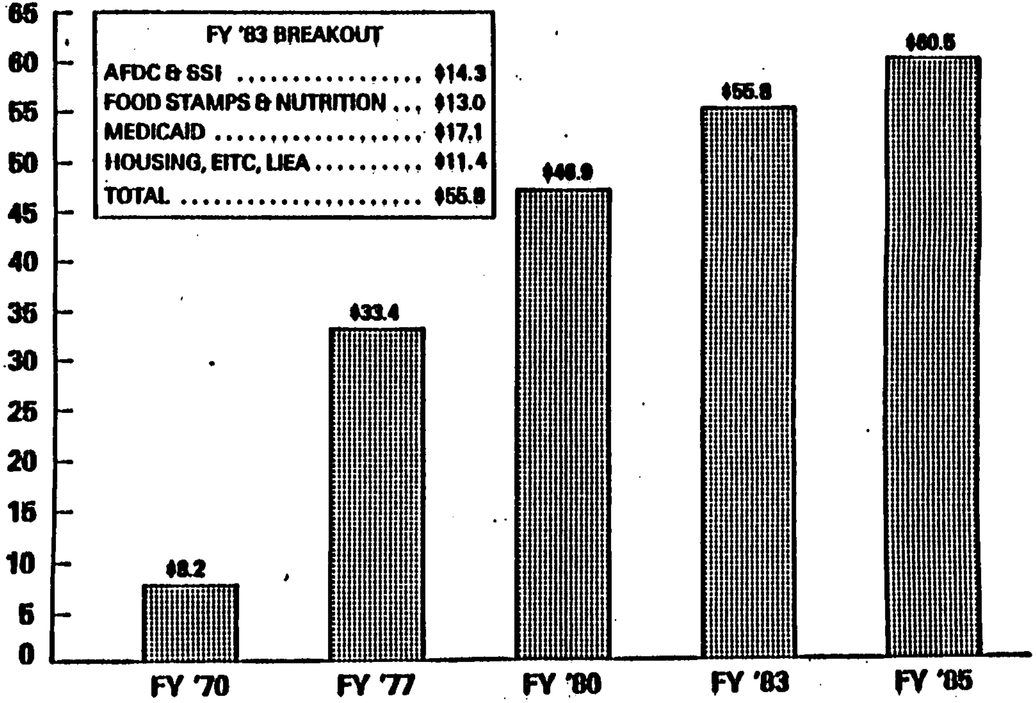


TOTAL: $14.5

HIGHLIGHTS

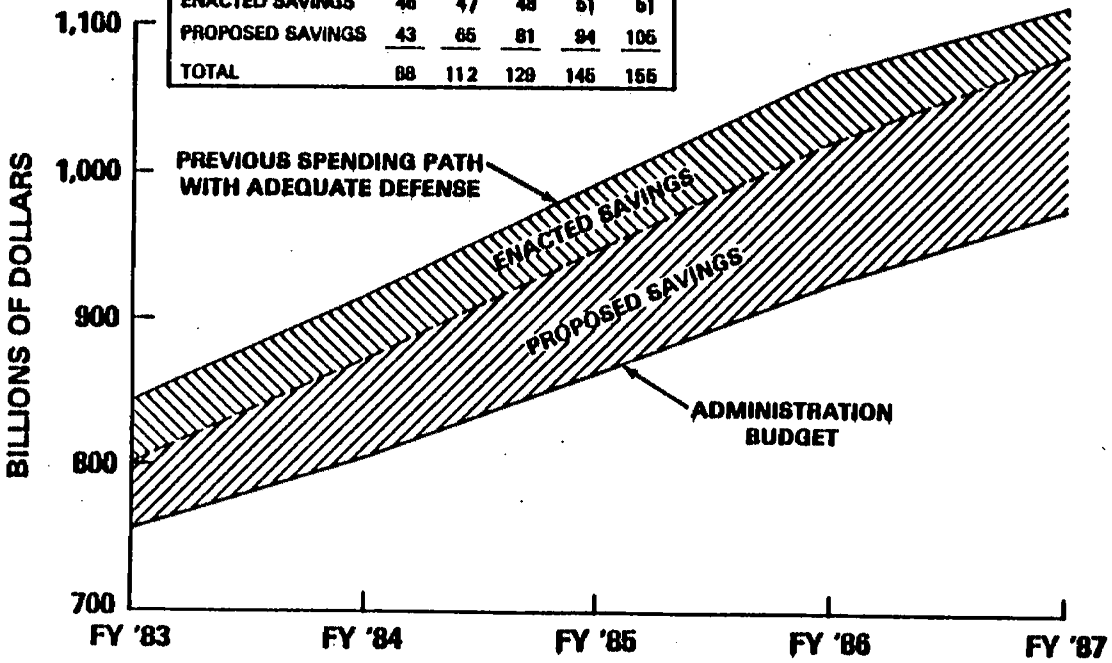
- 95 MILLION MEALS PER DAY
- 9 MILLION SUBSIDIZED SCHOOL LUNCH BENEFICIARIES
- 600,000 MEALS PER DAY FOR THE ELDERLY
- 18.6 MILLION FOOD STAMP BENEFICIARIES

FEDERAL INCOME ASSISTANCE FOR THE POOR



POLICY CHANGE — SPENDING TREND

	83	84	85	86	87
ENACTED SAVINGS	45	47	48	51	51
PROPOSED SAVINGS	43	65	81	94	105
TOTAL	88	112	129	145	156



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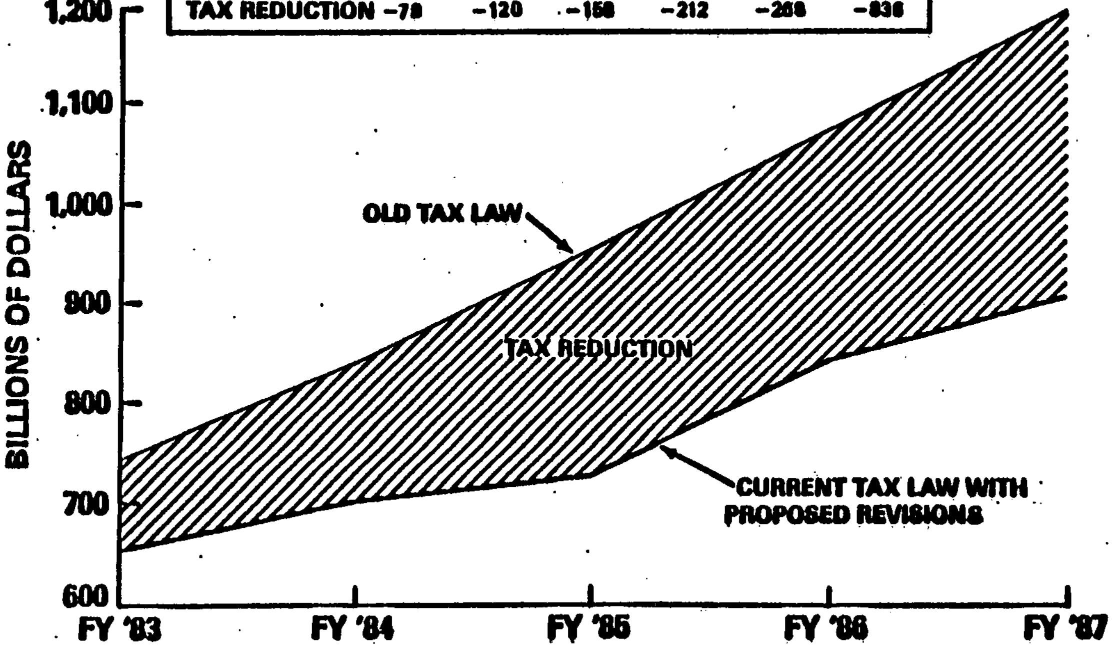
POLICY CHANGE — TAX REVENUES

	FY '83	FY '84	FY '85	FY '86	FY '87	TOTAL
TAX REDUCTION	−78	−120	−158	−212	−268	−836



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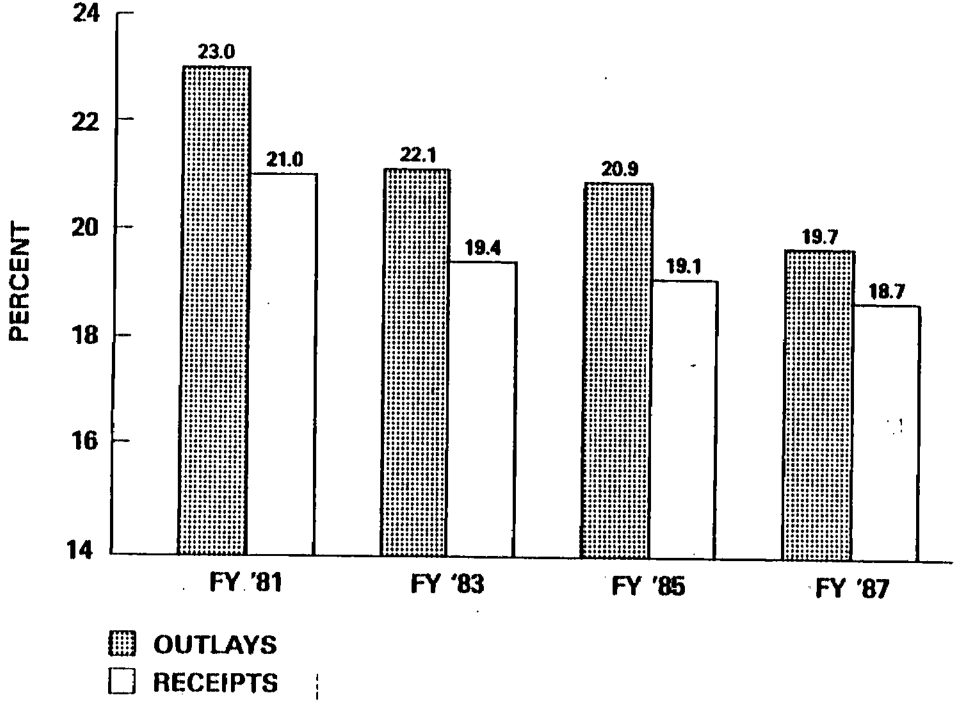
POLICY CHANGE — FEDERAL SHARE OF GNP



REALISM OF BUDGET FIGURES QUESTIONED

Representative RICHMOND. Thank you.

Mr. Stockman, what bothers me mostly is the rosy assumptions on which all of your budgets are built. You assume a deficit of $98.6 billion for this year; that's only under the best possible conditions.

I feel that the deficit will probably be closer to $150 billion. Why do I feel that?

First of all, you were a Member of Congress. You know how hard it's going to be for us to change tax legislation this year, an election year, and change quickly enough to affect this year's deficit. So, I think we really ought to look at a deficit of $150 billion.

Now, what does that mean? It means writing $150 billion worth of Treasury bills, right?

Now, with $150 billion of new Treasury notes, on top of the $1 trillion debt that we have, how do you plan your interest rates to go down to 11.7?

They won't. I figure your interest rates are going to stay at 15 percent.

So, here we have a deficit, the extent of which I disagree with you, to the tune of $50 billion, on the grounds that there's just no way this Congress can legislate the things you want fast enough, even if the Congress wanted to do it.

Unemployment, I don't believe, is going to go down to below 8 percent that you folks suggest. I think our unemployment figures are incorrect, to the tune of 1 million people anyway, because there are at least 1 million people in the United States who have never been listed as unemployed, who are relatively unemployable, since they never applied for a job. I think unemployment in the United States is closer to 10 million people.

Interest rates, as I said, I'm positive will be closer to 15 or 16 percent, and not 11.7. It's going to make it almost impossible for your inflation numbers to be anywhere below 9 percent.

Then, I worry about your tax revenues. This Nation is in a recession. American industry's decisionmakers are doing nothing to modernize their factories. Here, under the Reagan tax bill, we gave industry all sorts of tax benefits, in the hopes that they would modernize their factories.

What did they do? Machine tool orders last year were down, off 30 percent. Machine tool orders for the month of December alone were off 50 percent.

Now, where are we going to make the money, in order to give you the $627 billion worth of tax revenues?

I don't see it coming from industry. Heavy industry in the United States is in the worst condition that I can ever remember. Our steel industry is losing money; automotive industry is losing money; agricultural equipment industry is gradually going bankrupt. The finest company in the United States, Caterpillar, is only working part of the time. Our heavy industry is in a shambles in the United States.

So, for all of these reasons, I just don't believe any of your projections are correct.

I think we're headed for a very, very serious recession, and I believe you refuse to recognize it. In order for us not to have a recession, every one of your projections has to be correct.

Now, I've been in business all my life. I don't see how your projections can be correct, when you know very well that we have all of these unpleasant things happening right now.

The Secretary of the Treasury was here last week. He said that he thought we would be coming out of the recession in the second quarter. I indicated to him—I've known him for 25 years, and he's one of the greatest businessmen in the world—he knows better than that. Look at any company's backlog. Look at my own company's backlog. It's terrible.

We're not going to come out of the recession in the second quarter. I don't think we're going to come out of the recession this year. And I think it's incumbent on you, particularly, to let the American people know the truth. I think the quicker we know the truth, the quicker we'll all get back to work and realize this Nation is in a really severe condition, and we all better pitch in and start doing something about it.

Mr. STOCKMAN. First, Representative Richmond, let me point out the fiscal year 1983 budget runs mostly during calendar year 1983, which is about a year away.

Second, I admit the deficit in fiscal year 1983 would be $150 billion, if we didn't reform entitlements, implement some management initiatives, or make an effort to hold down discretionary programs and so forth. As an administration we are required, by law, to present a budget that lays out an action plan for this Congress. We propose—and now the ball is up here—and it is up to the Congress to dispose.

You may not accept all of these measures. You may not think it's realistic to do all of this work in 9 months. But we did as much, if not more, last year. We've done it in the past. Given the urgency of the situation, I believe we can do it now.

The difference between $147 billion and $92 billion consists of the action on the part of the executive branch and on the part of the Congress that we must undertake if we are to get the deficit out of the danger zone.

Representative RICHMOND. Let me interrupt you for a second because we each only have 10 minutes for questioning. How do you account to the fact that American industry is not responding to Reaganomics by reinvesting, modernizing, and spending their money on new———

OUTLOOK FOR BUSINESS INVESTMENT

Mr. STOCKMAN. My second point is that you assume the recession will go on indefinitely. I believe this is a very classic business cycle correction or recession in which certain forces have to unwind. The natural forces of recovery will be augmented and stimulated by the tax program that we put into effect last year. Why isn't business investing right now, breaking ground, hauling in machinery, and increasing the order book of the machine tool industry? Because firms never invest during a recession; as their operating rates are falling, they are liquidating investories and waiting for an upturn in business and new orders.

Representative RICHMOND. Why don't you factor that into your projections?

Mr. STOCKMAN. We have. Historic record shows very clearly that recessions do not last forever. In our modern economy we have built in forces and automatic stabilizers that will almost insure that any recession is of limited duration. That's been the record of recessions in 1958, 1960, 1970, 1975, and 1980. The economy will begin to pick up later this year and move into a full-throttle recovery next year.

Representative RICHMOND. You don't see a pickup in the second quarter, do you?

Mr. STOCKMAN. I didn't say that. I said later in the year. Now, a normal recession——

Representative RICHMOND. Don't you agree that before we have a pickup a few things have to happen? Factories have to modernize, labor contracts have to be changed, interest rates have to come down? All of these things have to happen before you can have a pickup. This Nation is built on housing and automobiles. You're not going to have a pickup in housing and automobiles until interest rates become reasonable.

Mr. STOCKMAN. I'll agree with that.

OUTLOOK FOR INTEREST RATES

Representative RICHMOND. With the type of deficit you're talking about, I don't see interest rates getting reasonable in the foreseeable future.

Mr. STOCKMAN. We would disagree strongly on that point. Credit demand in the first 6 months of this year clearly shows the financial markets of this country can accommodate the current recession induced deficit.

Representative RICHMOND. What are Treasuries selling at right now? Your last auction was 14 percent; right?

Mr. STOCKMAN. That's correct.

Representative RICHMOND. They're going to stay that way all this year.

Mr. STOCKMAN. That's one prediction. I think anybody who makes interest rate predictions ought to specify either the rate or the date, but not both. Everyone who has tried to predict interest rates has been wrong so badly so many times. However, if you look at the pattern underway in the economy, interest rates fell steadily as the recessionary forces began to work through the economy last fall. They began to rise in the last 4 or 5 or 6 weeks, due to what was feared in the money markets to be a temporary tightening of liquidity as the Fed tried to correct for the enormous money supply growth that occurred in November and December.

I don't think anybody has the answer to this. Before we make grand conclusions and pronouncements about the course of int rates over a year or longer, we ought to recognize those extre short-term forces at work. If this is a temporary liquidity sq in the money markets resulting from short-term manageme reserves, this uptick could well reverse. The process of reducing terest rates that was underway, could once again proceed, thereby creating the conditions for a recovery of the economy later in the year.

There is no guarantee where rates will fall. One thing that could interfere with that is a perception in the financial markets that the administration and the Congress are incapable of working together to deal with the outyear deficits. I don't think the 1982 deficit is bothering the markets. It's the outyear deficits. If we have some clear indication through the budget process this spring that we're bringing that under control, I see no reason why the interest rate decline shouldn't continue and the recovery get underway.

Representative RICHMOND. Mr. Stockman, my time is up, but I have a very, very good remedy for that $100 billion deficit. Let the President use his mind-boggling power to get the Japanese to give us equity in our trading relationship with them. You pick up $30 billion right now. Let's put in a share-the-burden budget and make tax users pay for what they use, yacht owners, private plane owners, people that use the Mississippi River. Let's repeal the deductibility of consumer credit. Let's do whatever is necessary to tighten up this Nation. We can save $44 billion with a share-the-burden budget. I've sent you any number of copies. No, I can't get anybody on your side of the administration to like it.

Mr. STOCKMAN. Congressman Richmond, may I respond to that one? We have some of your measures in the——

Representative RICHMOND. Let's cut the Defense budget by $20 billion. I'm sure there's $20 billion you can cut. All of these measures I have just outlined mean that you pick up $100 billion. Then your interest rates go down, Treasury bills go down, and suddenly it becomes feasible for people to buy a house again and to go back to work.

Thank you, Mr. Stockman. My time is up. Mr. Chairman.

Representative REUSS [presiding]. Senator Jepsen.

Senator JEPSEN. Go ahead, Mr. Chairman.

WHEN WILL THE RECESSION END?

Representative REUSS. Welcome, David. You have testified that in your judgment, the recession will be over later this year. I think that's what you said. If it ends on New Year's Eve you're all right with that prediction; is that not so?

Mr. STOCKMAN. Before 11:30. I wouldn't call it any closer than that. [Laughter.]

Representative REUSS. The Economic Report of the President released this noon, page 209, says, "The current recession is expected to end early in 1982." Do you agree with that?

Mr. STOCKMAN. Well, I imagine that you could find a way to define early, that would be reasonably compatible with what appears to be happening.

Representative REUSS. Let me have that again?

Mr. STOCKMAN. Congressman Reuss, I don't know what you mean by early. I don't think it means January.

Representative REUSS. It wasn't my word. It was the Economic Report.

Mr. STOCKMAN. I think I agree with it, but I reserve the right to define early. [Laughter.]

Representative REUSS. Up to and including New Year's Eve? [Laughter.]

Mr. STOCKMAN. No.

Representative REUSS. When does early cease to exist?

Mr. STOCKMAN. Congressman Reuss, you're one of the great students of the economy in this Congress, and you know that to define the end of the recession or the beginning of the upturn in some technical sense isn't easy. Is it the time when inventories stop liquidating and start increasing, even though there are many apparent signs that the economy isn't moving upward? Is it the time when consumer sales start rising? Is it the time when the housing market, which usually leads the recovery, begins to move upward as it is?

There are many different ways to define it. We're saying generally, that the indicators in the last 3 months have all been pretty flat. Some are turning up and few are going down any further. That is a sign that we've hit the plateau and that the conditions are being created for recovery.

VOLATILITY OF MONEY GROWTH

Representative REUSS. Flattery will get you someplace with that.

Let me turn now to money. Before this committee, on October 28, you were asked what about the volatility, the variations in M_{1B}, and you replied, and I'm quoting from your testimony:

> The measure of the money variable M_{1B} being affected by changes in financial deposit practices for only a few weeks or a few months, doesn't really tell for only a few weeks or a few months, doesn't really tell the story. I would at least suggest that we look at a year, or at least the last 9 or 10 months. It seems to me that what we ought to do is not quarrel with the monetary policy which is correct, but address the problem that we are jointly responsible for, and that is the fiscal policy of the budget and the deficit.

In our hearing earlier this year, Secretary of the Treasury Regan asked about this same volatility of M_{1B}, testified, and I quote:

> M_{1B} isolated from week to week in the 6 months from April to October, the net change was a decrease of 0.1 percent. Such volatile money growth has very damaging effects on the economy. It destroys the credibility of long-run monetary controls.

Do you agree with Secretary Regan?

Mr. STOCKMAN. Congressman Reuss, my primary responsibility is the fiscal problem of the budget. I think any comments I might make outside of that area are only my own general observations. I don't think the two are entirely incompatible in the sense that we have had enormous breaks in the path of M_{1B} that are problematic. I think that's what Secretary Regan has been pointing to. If you look at changes in M_{1B} on a week-to-week basis you are probably witnessing a recorded noise rather than something significant.

I do think that a drop in money growth from May to October followed by a huge burst from October to January is not without significance. That has had an impact on the financial markets and on the real economy that is beyond the scope of what I was addressing in my remarks last October.

Representative REUSS. When you said that what we ought to is to look at a period of a year, or at least 9 or 10 months——

Mr. STOCKMAN. Yes, we should. From the longer run perspective, I believe the Fed's policy and its implementation is moving in the right direction. But enormous volatility in a shorter period of time—not just small swings, but enormous volatility—can be problematic, given the present delicate state of financial markets and the pervasive uncertainty that prevails.

CONFLICT BETWEEN VELOCITY AND NOMINAL GNP FIGURES

Representative REUSS. Let's now talk about your economic game plan for fiscal 1983. Your budget calls for a nominal gross national product to rise from 9.3 percent in 1981, to 10.4 percent in 1982, to 11 percent in 1983. The administration supports the Federal Reserve's target growth rate for the money supply for 1982 of 2.5 to 5.5 percent. Assuming the Federal Reserve hits the midpoint of the target, which is about what the administration and the Fed want it to do, this means that you have got to have a 6.5-percent increase in velocity in 1982 which is twice the historic average of around 3 percent.

Furthermore, if the money supply falls to 3.5 percent in 1983, which I think is what the administration wants it to do, velocity would have to rise to 7.5 percent to support the nominal GNP. What reasons do you have for expecting the sensational increases in velocity, more than twice the historic rate?

Mr. STOCKMAN. Basically, Congressman, we don't expect them. I think you're comparing year over year nominal GNP to the Fed targets, which are fourth quarter to fourth quarter. Although that sounds like a technical distinction it's very important.

Representative REUSS. If I may interrupt, the figures I gave you were fourth quarter to fourth quarter. If I'm wrong, please correct me.

Mr. STOCKMAN. What figure did you give for 1982?

Representative REUSS. The figure is fourth quarter to fourth quarter of nominal GNP were 9.3 percent in 1981, 10.4 percent in 1982, and 11 percent in 1983.

Mr. STOCKMAN. In 1982, we support the Fed's target range of 2.5 to 5.5 percent. I don't think we have ever pinpointed a precise estimate of money growth. Secretary Regan said on a number of occasions that it ought to be in the upper third of the target range. If money growth is about 5 percent. I don't think you're stretching the historical experience to expect a velocity factor that would reconcile the 1982 GNP growth.

Representative REUSS. The Fed says 4 percent. So said Volcker this morning. But let's get back to the velocity. What is your basis——

Mr. STOCKMAN. The fourth quarter of 1981 was depressed because GNP fell by a hefty 5.2 percent. The fourth quarter of 1982 reflects the first strong quarter of recovery in our forescast. On a fourth quarter basis, it seems that there is a large change in GNP. On a year over year basis, however, it is about 8 percent. I don't think there's an iron rule that would track velocity and GNP on a quarter-by-quarter basis. As a matter of fact, if you look at the first quarter of 1981, you had about a 19-percent growth in nominal

GNP and you had a 5-percent growth in money, and you had a huge velocity for a short period of time.

If you want to assess the compatability of what we have advocated on monetary policy with our forecast, look at it on a year-over-year basis for the 1982-84 period. Take into account what we know about the tendency of velocity to accelerate during a recovery. Take into account the full range of the Fed monetary target, not simply an arbitrarily chosen midpoint. I think you will find it is generally compatible, although some of the monetary technicians and the purists wouldn't like the fit. But frankly, if the Fed came in with 2.5 percent in 1982, we wouldn't get out of the recession. And if it came in with 2.5 percent during the 1983 recovery year we wouldn't recover.

The point is the Fed has a target range, but also has some ability to deviate within that range, in light of the other policy goals we have in place.

Representative REUSS. Let's assume, however, that they do what they said they were going to do and what the administration seems to approve: Increase M_1 at a rate of 4 percent. What kind of velocity to you need to validate your GNP target?

This is very important. It's just as important as the——

Mr. STOCKMAN. I suppose if you did some math, it would be in the 5- or 6-percent range.

Representative REUSS. That's twice the historic average.

What financial events do you expect to take place, to produce that quantum jump in velocity?

Mr. STOCKMAN. Well, Congressman Reuss, I would prefer not to discuss this in any greater detail, because this isn't my primary area of responsibility, nor the purpose that I agreed to come to testify before the committee.

First, I do not think the historic average should be used in reference to an economy that is undergoing a transition. Second, the choice of a money growth projection, be it 4 or 5 percent, can result in different conclusions. One must be extremely cautious when measuring GNP from one quarter to another quarter, when the economy is going through a cyclical swing.

DOES BUDGET IMPLY CONTINUED HIGH INTEREST RATES?

Representative REUSS. Sure. That's why I'm happy to look at it on an annual basis with you. But let me ask you one more question.

You, in your budget projections, project a happy—and oh, I hope you're right—lowering of interest rates: 14 percent in 1981, 11.7 in 1982, and 10.5 percent in 1983. The one factor I know of which is preeminent in making for greater velocity of money is high interest rates. That causes people never to let a dollar to stop rolling, because interest rates are high and they want to turn that dollar over.

Could it be that your superhigh, hyperthyroid velocity projections indicate a lurking belief that we really are in for the regime of interest rates, as far as human eye can see, at an intolerably high level?

Mr. STOCKMAN. Well, it is not our belief, expectation, nor our intention that anything of that sort would happen.

With a fertile imagination, you can probably string together all kinds of assumptions and numbers, and come to that conclusion. I counter that by saying that these interest rates are part of an overall forecast. Embodied in the T-bill forecast is about a 4-percent premium above the inflation rate for each of those years. A 4-percent real rate of interest is historically high: over the last decade, the real rate on the T-bill has averaged less than 1 percent, it has been negative. Thus, I can say our interest rate forecast is not too optimistic.

As this economy unwinds and inflation comes down there still will probably be continued uncertainty in the financial markets. There will be a higher-than-historic interest rate premium. Nevertheless, the rate is coming down, which is more than compatible with our overall forecast.

I don't think you can look at just one variable at a time. You must consider the total picture—money, GNP, inflation, growth, and interest rates—and say, "Does it all stack up? Does it all fit together?"

I think we have a pretty plausible case. But you can come at it from any number of angles and say, "I have a different view." And that, of course, is what this whole debate is about.

Representative REUSS. Thank you. Senator Jepsen.

Senator JEPSEN. Thank you.

SOIL AND WATER CONSERVATION SPENDING

First of all, let me commend you for your attention to detail in the areas, especially, of soil and water conservation, which is very near and dear to my heart, being from Iowa and being chairman of that subcommittee.

I received some panic calls, in that the new budget shows a reduction of 10 percent in general in the soil and water conservation service area. But after closer examination of the technical asistance, which really hits home, for soil erosion in my State, I see it's been increased by 8 percent in that figure, a $26 million increase.

To go into those small details in that big, thick budget and have that type of industrious attention paid to what I consider to be priorities, I think is certainly a great credit to you and your ability to master and handle the entire budget.

ACCURACY OF PROJECTED BUDGET DEFICITS

Budget deficit forecasts, we know, are notoriously inaccurate. In January 1978, for example, President Carter projected a deficit of $61 billion in 1979; but the actual deficit turned out to be only $28 billion. And in January of 1981, the year that we just came off, in the last fall, the outgoing Carter administration forecast a deficit of $28 billion for 1982; that figure will be closer to a hundred billion, as we all know now.

So, it does seem that one should hesitate before making too much out of a number which can easily vary by many billions of dollars, in either direction.

At the same time, we have to have guideposts, guidelines. And it is my opinion in this budget—and I would like to comment on this budget—that very, very conservative estimates were made by way of income and changes in revenue, but very liberal estimates were made of where the deficit might be.

Is that correct? Is the deficit really a figure that's pie in the sky?

Mr. STOCKMAN. Well, Senator Jepsen, I appreciate what you have just cited, in terms of the notorious inaccuracy of past budget projections. However, the actual inaccuracy is even greater than you mentioned.

If you look at the 1978 budget document, you will find a forecast surplus of $85 billion for 1981, which turned out to be a $60 billion deficit. That's a swing of $140 billion over a 3-year period.

In addition, the economy is in such an uncertain state that the course over the next 2 years is difficult to predict. We have provided, in part 2 of the budget, alternative projections of this budget, with all of the policy actions, cuts, and reforms, according to different sets of economic assumptions.

If you want to be more pessimistic, we don't require you to go to CBO; it's already in the budget. A lower real GNP growth rate, a higher inflation rate, and higher interest rates generate much higher budget deficits than we are proposing.

If you want to be more optimistic, we have also provided budget projections which assume a higher growth rate, a lower inflation rate, and a more rapid fall in interest rates.

EFFECT OF DIFFERENT ASSUMPTIONS ON DEFICITS

I would just like to call this to the attention of the committee. In 1985, we projected a $71 billion deficit, on the basis of the forecasts that Representative Reuss and I have been discussing here. If real growth is 1.2 percent higher and inflation is 1.2 percent lower, the deficit would be only $24 billion in 1985.

On the other hand, if real growth is 1.2 percent lower and inflation is 1.2 percent higher, then the fiscal year 1985 deficit would be $120 billion.

The chart on page 211 of the budget compares assumptions for real growth, inflation, GNP, unemployment, and interest rates, to determine which assumptions you think are plausible based on your notions concerning the economy and recast this entire budget in terms of the outcome that you think is most appropriate.

In other words, the policy is the same. The spending commitments are the same. The defense budget is the same. The entitlements are the same. All policy is held constant. What is varied here is the economic forecast, which has an enormous impact on the budget. It can swing the deficit anywhere from $24 to $120 billion 3 years out, simply by a 1.2-percent change in the real growth, inflation, and interest rates.

That is the difficult environment we are working in. Everyone should understand that we're going to have to make the best call possible. We did, and it is embodied in our forecast. The Congress must do the same, as you write a budget resolution.

Everyone should recognize that, for the next several years, the performance of the economy will drive the size of the deficit, more than anything else. To maximize the performance of the economy, we ought to do everything we can to reduce the underlying imbalance of revenues and outlays.

ANTIRECESSION POLICIES NOW IN PLACE

Senator JEPSEN. The Congress did pass certain laws last year, that put in place the types of economic doctoring—or incentives, or whatever you want to call it—that, in past history, have usually not been acted on, or talked about, or even debated until a recession was way down the line and we had been in for a while.

Here we find ourselves at the front end of a recession, as it turned out, with all of these things in place. I think that should result in a big plus as this thing does begin to turn around, don't you?

Mr. STOCKMAN. I agree. I think this is almost unprecedented, to have most of the necessary measures in place ahead of time with no need for the kind of ill-considered and almost panicked legislation action that we have had in times past.

Each time we have done this, the committee has undertaken a report 3 years later. The reports of this committee have proven, time and time again, that those emergency antirecession measures didn't work. They came too late, causing higher inflation during the recovery, rather than causing expansion during the recession.

With that track record, I think we can consider ourselves fortunate that we have acted already, in that this recovery can pick up steam once the business cycle forces have worked themselves out.

IS BUDGET BEING CUT?

Senator JEPSEN. One quick question. Over the last year, we have heard a lot of discussion about the Draconian budget cuts from various segments of our society.

What are the facts?

Is the Federal budget really being cut, or is it merely growing at a less rapid rate?

Mr. STOCKMAN. Senator, the answer is that outlays are growing at a less rapid rate. Some programs are being cut, but the budget as a whole obviously continues to expand. Even after enacting our proposed fiscal changes, you would still have spending of $758 billion, compared to only $493 billion in 1979, only 2 years ago. The budget continues to grow as the expenditures continue to increase, even considering all of these changes.

REVENUES FROM SALE OF FEDERAL ASSETS

Senator JEPSEN. What initiatives, if any, are being considered to dispose of Federal assets, to raise funds?

And what are the items most likely to bring the most revenue? Are we considering this?

Mr. STOCKMAN. Yes. We have a major component in the budget that would bring in $1 billion in additional revenues in 1983 and $4 billion per year thereafter. Basically, it is premised on two guidelines:

First, stop giving it away free, which is what the Federal agencies tend to do today. They have excess property—real or land—and give it to another agency or a State or local unit of government.

Second, stop holding it; start moving it. A property review board, to be organized in the Executive Office of the President, will be in charge of the coordinated effort to find those properties that can be disposed of at market value in order to bring receipts into the budget. The effort will be directed at both real property holdings of GSA as well as unnecessary land holdings of the USDA and the Interior Department, without in any way impairing or impinging upon important national assets—our forests, park lands, and wilderness areas.

Frankly, I can't go into all the details of this here. It is a very complicated, far-reaching issue. We are confident, however, that these numbers are conservative, because there is much that can be done to improve the budget posture in this area.

Senator JEPSEN. I thank you. And I thank you for all the good work you are doing.

Representative REUSS. Senator Proxmire.

Senator PROXMIRE. Welcome, Mr. Stockman. I am very happy to see you before us.

CRITICISM OF THE BUDGET BY REPUBLICAN ECONOMISTS

Mr. Stockman, I am concerned about the fact that the economic plan of the administration seems to have such very thin support. I notice that yesterday three of the outstanding economists who had served in previous Republican administrations really kicked in hard against the budget and the GNP forecasts and so forth.

They included William Fellner, who was a member of President Ford's Council of Economic Advisers; Herbert Stein, who was Chairman of President Nixon's Economic Advisers; and Rudy Penner, who was the Chief Economist at OMB in the Ford administration.

These aren't Walter Heller or John Kenneth Galbraith. These are your buddies, your friends. And it seems that the administration is pretty isolated as far as economic professionals are concerned here.

Let me just give you some of the criticisms and ask your comment.

HIGH GNP FORECASTS CONSISTENT ONLY WITH HIGH INFLATION

William Fellner said the administration is projecting about a 10-percent annual increase in gross national product for several years. That's nominal, of course. He said we have never had a period of such increases that were not inflationary. Moreover, such large increases in nominal GNP, which includes real growth in output and inflation, are not consistent with the Federal Reserve's policy of restraining growth of the money supply.

What's your answer to that?

Mr. STOCKMAN. Well, Senator, I have observed that if you are on the outside at AEI or some academic post, you tend to be more doctrinaire than when you're inside grappling with all kinds of variables as you try to reconcile and aggregate several different factors, whether it's to produce a forecast, a budget, or a policy.

And I think there are some monitors who are looking for such mathematical precision in the forecast and in the path of Fed policy that they are ignoring some real-world factors. Those who have responsibility for establishing policy for the well-being of the country and for progress on all of our goals, must take a more serious and comprehensive look at these factors.

Senator PROXMIRE. These are pragmatic, practical, tried economists who have served in these positions. They have served in the Council of Economic Advisers; they've served as the Chief Budget Officer of the United States. They're sympathetic with your position, they support Republican policies, and they're saying what you're doing won't work.

Mr. STOCKMAN. I don't think their points extended to the entire fundamentals of the economic program or this budget, but were limited quibbling about the path of nominal GNP in this budget.

And the only thing that I can say is that, compared to what happened to nominal GNP in the last half of 1980 and 1981, when it was growing at the inflationary rate of 15 percent, we're bringing it steadily down into single-digit range. That is supportive of the monetary policy and of the continued lowering of the inflation rate.

If you want to get into mathematical precision, then there is room for extended debate over a long period of time.

HIGH DEFICITS MEAN HIGH INTEREST RATES

Senator PROXMIRE. Without getting into mathematical precision, just taking a rough direction, Stein said the President relied on the high projected rate of economic growth in order to show the deficit declining from $98.6 billion this year to $53.2 billion in 1987. And under a constant instead of a rising economy, you would have rising deficits.

Furthermore, Fellner said that the $83 billion deficit forecast for 1984 for instance—and that's a very optimistic assumption in my view and in his view—would absorb near 30 percent of the approximately $280 billion of the net new savings by that year by individuals, corporations, and State and local governments.

Such a high percentage was reached only once so far in an economic expansion. That was in 1978. The administration has cited that year as part of the fiscal policy excesses contributing to the country's current economic difficulties.

In other words, what he's saying is you're going to have so much borrowing by the Federal Government that you're going to have high interest rates during this period, right through 1984 and later.

Mr. STOCKMAN. I think, in terms of that general warning, it's something we ought to keep in mind. If decisive action isn't taken to reduce these deficits to the maximum degree possible, we increasingly run the risk of preventing the program from moving forward and the recovery from taking place.

I don't think you can talk about deficits or borrowing as an on-off, either-or phenomenon. It depends on their magnitude. The higher the magnitude, the greater the problem. We've reduced them as far as we think is possible, given what the Congress would be likely or capable of doing during the present budget period.

We have a $239 billion action plan on the plate. If we overload the wagon, we'll get nothing. The resulting $150 to $180 billion deficits would make that kind of academic criticism entirely moot.

BYRD PROPOSAL THAT BUDGET BE WITHDRAWN

Senator PROXMIRE. Let me ask you about a letter that was just written today to the President from the minority leader in the Senate, Senator Robert Byrd.

Senator Byrd makes an interesting suggestion to the President. He says—he suggests that he withdraw his proposed fiscal 1983 budget, resubmit a budget that provides for much lower deficits, and make use of more realistic assumptions.

He points out economists of all political stripes—and I've just cited three of them—believe it contains economic assumptions that are overly optimistic.

He also points out that in 1980 President Carter did exactly that, he took the bold step of substantially revising his fiscal year 1981 budget.

Is there any prospect that in view of the overwhelming criticism, the reaction by the financial markets, that the President may reconsider and come in with a budget which would give us lower deficits?

Mr. STOCKMAN. Senator, I don't think so, particularly on the basis of that example.

As I remember, the budget was withdrawn because of policy considerations. There were extended meetings in March and April, and by May we had a new approach and a new budget. In June, we had a budget resolution that was balanced for fiscal year 1981.

And it turned out to be $58 billion in deficit primarily because the economic assumptions were worse than the first ones. So, I don't think that that was a very productive precedent to harken back to.

Senator PROXMIRE. I agree that we make mistakes, but the point is we have a recent precedent where a President did revise his budget.

Mr. STOCKMAN. I think the normal course, Senator, is that the administration sends up a budget, which is then assessed, analyzed, adjusted, and modified by the Congress. In my view, that is the path that we ought to follow at this time, rather than going through the formality of putting a different cover on it.

Legislative process this year will be difficult; several options will develop. I think we ought to let the process take its course, not pretend that we should start over. Because, frankly, although I hear criticism that these deficits are too big or these entitlement cuts are wrong or this defense increase is too large, I think when people start to look at the practical options and alternatives, they will find that they are few and far between.

SHOULD THE JULY 1 TAX CUT BE ACCELERATED?

Senator PROXMIRE. Let me ask you about another option. That's the option proposed by a number of Members of Congress, including some prominent members of this committee, including the chairman and vice chairman, and that is the option that we move the July 1 tax cut to January 1, 1982, make it retroactive, that is, and provide for a stimulus, an immediate stimulus to the economy to begin moving us out of the recession promptly. I do not support that, but I'd be very curious to know what your position is on it.

Mr. STOCKMAN. I don't think that we have given any serious analysis or consideration to that. Our budget is 3 days old. We expect to defend it for a while before we take a look at 2-day options that have appeared from elsewhere.

As a practical matter, since it would take us 2 months to pass a bill and longer to change the withholding tables, there wouldn't be extra dollars in people's pockets before July anyway. People would either receive a higher withholding rate for the rest of the year or a rebate next April.

I don't see where anything could be done to spur the economy right now, given the practical logistical framework and restraints that we're under. You couldn't really change things this late in the game.

Senator PROXMIRE. Recognizing it might take some time and it might take a couple of months, the psychological effect of the Congress working in that direction, the President calling for a sharp reduction retroactive, wouldn't that be beneficial, or would it?

Mr. STOCKMAN. There's no reason why the recovery shouldn't go forward, propelled by the normal business cycle forces and by the tax cuts that are now in place.

The worry in the financial markets is not the absence of some kind of anti-recession antidote, but rather the threat of large budget deficits in the future that aren't being addressed and cured by the political process. If we want to do something to keep interest rates trending down, and insure that recovery goes forward, we must address ourselves not to 1982 but to the 1983 budget. We must work on permanent policy measures that will substantially reduce the gap between revenues and outlays.

Senator PROXMIRE. I agree with that.

PROPOSAL FOR SELECTED TAX INCREASES

Let me ask you why we couldn't give real consideration to some revenue increases, some tax increases right now that would help reduce the deficit?

Let me give you just a quick series that would add up to $18 billion:

Repeal expensing of oil and gas drilling, $3½ billion.

Liquor tax, $3.3 billion.

Windfall tax giveback, $1.6 billion—in other words, restore that.

Cigarette tax, $1.8 billion.

Luxury tax on furs, jewelry, and so forth, $2.5 billion.

Business entertainment expense—knock that out—$1.5 billion.

Leasing losses, which we provided, $2.8 billion.

And then an antipollution tax, which would help the EPA and reduce our expenses, we estimate that at about $1 billion.

The other estimates come from the Treasury itself on the basis of previous recommendations.

That's an $18 billion beginning.

And I don't have time—but maybe in the second round I can also ask you about some further reductions in spending that would help.

Why wouldn't that make a beginning toward reducing the deficit and do it in a constructive way, without hurting people who have already made sacrifices?

Mr. STOCKMAN. Well, Senator, in our budget, we have proposed a somewhat different set of measures and numbers.

Senator PROXMIRE. I would add to what you've done.

Mr. STOCKMAN. The feeling of the administration and the President is that additional revenues in this budget can contribute to solving the problem. Such increases in revenues are very selective and limited to eliminating obsolete tax incentives or strengthening the minimum corporate tax that has simply not been effective. That is as far as we should go in terms of solving this problem by raising revenues.

What we need to do instead is look at the other four areas of the budget in our five-point plan: User fees; entitlement reforms; asset sales, and management initiatives, to provide the additional contributions to close the budget gap.

So, we have provided the precedent, and that's part of the plan. You must have a balanced policy to have a good mix. We think this is the best mix that we can propose.

CUTS IN STATISTICAL PROGRAMS

Representative REUSS. Mr. Stockman, this morning the Joint Economic Committee heard from a number of the Nation's leading economists who told us how helpful the statistical program had been known as "Survey of Income and Program Participation."

That program, conducted by a small group of statisticians, was concerned with the measurement of income and wealth and also with the measurement of waste which occurs when families and individuals are simultaneously receiving overlapping support from more than one program.

One of the witnesses, Prof. James Smith of the University of Michigan-Ann Arbor, had something to say—which, incidentally, is very flattering to you. And I want to read it to you.

He laments the fact that this program apparently has been abandoned. And he and other witnesses told how serious a blow that is to good statistics.

He says, and I'm quoting from Professor Smith, "I can only conclude that the program was terminated by an overzealous, lower level bureaucrat, rather than by Mr. Stockman."

What do you know about that?

Mr. STOCKMAN. Well, Congressman Reuss, it must have been an overzealous, lower level bureaucrat, because I haven't ever heard of it. But I will go back and take a look at it.

I have to say that although we collect many statistics, I'm often amazed that I never can get answers on the serious policy questions that we need to respond appropriately to Congress.

One area has been the overlap of benefits. I have asked, time and time again, "Give me the crossbar between SSI and food stamps;

and housing subsidies and medicaid and medicare." And it can't be done.

So, I suspect that maybe this was a worthwhile program. Unfortunately, thus far it has not produced relevant answers. We will take a look and see why that happened. I'm sure that was a decision made way down there in the bureaucracy.

Representative REUSS. You would gratify a lot of people if you can rescue it. I believe it's a very cost-effective program, because the number of people it took to keep those statistics on wealth, income, and waste, by simultaneous overlap, was very small.

So, I will appreciate your looking at it. And would you let the committee know——

Mr. STOCKMAN. I certainly will, Mr. Chairman.

Representative REUSS [continuing]. Whether you will be able to reinstate it.

I can say, for myself, that it has been enormously helpful.

INCOMES POLICY

Let me now turn to a fundamental question. As you said earlier, your main concern is with the budget, spending, and revenues. And that's as it should be.

I don't know how much you know about so-called incomes policies—and that is not a budgetary problem—but we had some very interesting testimony before our committee in the last few months from people from Austria and people who had studied the incomes policies of Finland and the Federal Republic of Germany, the net of which was that a good, well-thought-out incomes policy, on top of sound fiscal and monetary policies, can make some useful contact with inflation and bring it down.

I'm not going to ask you whether you believe in an incomes policy. Just take it from me that us benighted Democrats think it would be a help.

Now, would you turn to page 211 of the budget, because it's very intersting. There is a table there called Effect on Deficit of Shift in the Composition of Nominal GNP, and it contains two alternate columns: One, what happens to the deficit—and you and I don't like deficits—what happens to the deficits under the administration program, and what would happen under a program of higher growth and lower inflation.

And just following the two across the board, in 1982, it's about the same. The administration's program is a $98 billion dedicit while the higher growth, lower inflation assumption has a deficit that is almost as bad, $94 billion.

But then as you go out, a nice gap appears between the two—1983, it's $91 billion versus $74 billion. 1984, it's $82 billion versus $50 billion—making progress here. 1985, $71 billion versus $23 billion. 1986—hallelujah, it's $66 billion on the administration's game plan and a balanced budget, zero deficit, under the higher growth, lower inflation scenario.

From then on, it gets even better. But let's just settle for a balanced budget for a moment.

Could it be that if our democratic alternative of somewhat less restrictive money and an incomes policy to keep inflation down at a time when only 73 percent of our resources are being used—could it be that that policy might have something to be said for it? And if something could be said for it, wouldn't it be a wonderful world if we could bring that deficit down to zero by 1986 instead of staggering along with your $66 billion deficit?

What do you think?

Mr. STOCKMAN. Mr. Chairman, I think it would be a wonderful world.

Representative REUSS. You are a clear-minded man.

Mr. STOCKMAN. I think it would be a wonderful world, but I would point out that a higher growth scenario has an average GNP growth rate of slightly under 6 percent for a 22-quarter period, beginning in 1982 all the way through 1987. The average real GNP growth rate since World War II has been 3.5 percent.

I checked out every 22-quarter period from 1947 to the present, of which there are 118 such periods of 22 quarters, and not in one period has there been anything above 5.9. And in the 118 periods, it's been well below 5.9 percent.

Certainly we would like to see that kind of sustained growth, which would improve the budget, but I fail to see how an incomes policy could produce such a miracle.

Under the current economy, I don't believe that an incomes policy is going to add anything to the fairly rapid reduction of the inflation process in our economy. Inflation is coming down.

Representative REUSS. At the cost of 10½ million unemployed, which neither you nor I like.

Mr. STOCKMAN. I agree with that. We most certainly don't like unemployment. It seems to me you are proposing a tradeoff, give some faster money growth for a while and try tro keep the same progress on inflation going foward with an incomes policy.

Representative REUSS. A fair statement. And what's wrong with that?

Mr. STOCKMAN. Well, because I don't know how an incomes policy manages all those millions of minds in the financial markets that respond to what they think the Govenment is trying to do with their money.

Now, we might be able to manage the wages of a few workers who happen to be in the UAW or the Steelworkers Union, or the prices of a few big corporations. But the inflation process consists of the actions of millions of people every day, and I don't know how we would change that if we go back to a policy that says we're running the risk of a return to rapid inflation and money credit growth.

Representative REUSS. Suppose President Reagan and Chairman Volcker had a press conference tomorrow and said, "Look, we can't go on like this, the 73-pecent utilization of our industrial potential is wicked. So, we're going to adopt a new policy," one where Mr. Volcker has promised, "modest increases in the money supply necessary, and not 1 penny more, to increase the rate of utilization to 80 percent."

"And for our part," President Reagan would go on to say, "we are asking Chancellor Bruno Kreisky of Austria to come over here and institute—tell us how to institute the kind of government, business, labor—all for one, one for all, and for the common good incomes policy that they have over there."

Do you think Wall Street would go bonkers at that announcement anymore than it is this week?

Mr. STOCKMAN. Well, Mr. Chairman, I would like to think that it would have a salutary effect, but I'm afraid it would evoke a yawn. We've tried it before.

We had a gentleman in the previous administration who was colorful and invented terms like "banana." He did his best for 2 years to talk down wages and to talk down prices. He had high-level negotiations at the White House in which everybody said they agreed to a noninflationary, collective-bargaining settlement or pricing policy. But everything got worse and the price level went up because the monetary policy was wrong.

Representative REUSS. You, of course, are knocking out the two props of my thesis; namely, that an incomes policy can work, in my view, only if it is a gloss on a sensible fiscal and monetary policy.

Mr. STOCKMAN. That's different.

Representative REUSS. We didn't have that. I'll be the first to admit.

Mr. STOCKMAN. That's different.

Representative REUSS. Well, I will end right there. Senator Mattingly.

Senator MATTINGLY. Thank you. Mr. Stockman, its, good to see you.

I have an opening statement I would like to enter for the record.

Representative REUSS. It has been placed in the hearing record.

Senator MATTINGLY. Thank you.

IS THERE A NEED FOR ALTERNATIVES TO THE BUDGET

Now we will get to the germane part. I would like to welcome you back to "Criticism Hill." I think that by the time we get back from recess you may have 535 budgets facing you, in addition to your own.

Do you think that some of these might be helpful to you though?

Mr. STOCKMAN. Obviously the purpose of a President's budget is to lay out a plan; to lay out proposals that can get you there: and then to give the Congress a chance to scrutinize and analyze, and see whether there are any alternatives available.

We expect that to happen again this year, just as occurred during the process last year. There will be useful and important options developed, but I don't think anybody is going to come in with a grand panacea, whereby they can simply wave one wand and solve this problem with something that's radically different than what we have proposed.

As I have indicated before, once you get away from the grand level of abstractions and get down into the nitty-gritty details of policy, budgets, and costs, the options are few and far between.

Senator MATTINGLY. But you are going to welcome the alternative——

Mr. STOCKMAN. Most certainly.

REVISIONS NEEDED IN THE CONSUMER PRICE INDEX

Senator MATTINGLY. Let ask you another question, do you agree or disagree that there's no way to ever balance the budget of this country until we control the entitlement programs?

Mr. STOCKMAN. That would be an essential precondition.

Senator MATTINGLY. You know, I have been very concerned with the inaccuracy of the CPI, as far as calculating the cost-of-living adjustments for all Federal entitlement programs, because there is an inaccuracy in those calculations, and inflation is definitely fueled by that. Isn't that correct?

Mr. STOCKMAN. The CPI is a far from perfect measure. In the past several years, it has tended to overstate the underlying or the more broadly measured inflation rate. Having said that, I think you also have to recognize that most of the alternatives that have been proposed aren't that much better.

Senator MATTINGLY. But there are alternatives? There is a better way than the usage of the current CPI, in order to have a true calculation of the inflation rate that we index the entitlement programs and other programs with?

Mr. STOCKMAN. I think its would be possible.

Senator MATTINGLY. Does the administration intend to address this issue?

Mr. STOCKMAN. Yes. I think we have. The President believes that the bipartisan commission which has been appointed to look at all of the issues regarding social security—the principal indexed program—will provide constructive suggestions for the Congress to address, and hopefully implement, in the relatively near term future.

This wouldn't be in time for this budget cycle, but certainly in time to affect the 1983 or 1984 outyear budgets that we're also concerned about.

Senator MATTINGLY. If there was a calculation that came up, that was agreed upon by a large number of economists and people across this country, would the administration be willing to accept a new factor?

Mr. STOCKMAN. We would have to see it first, and would have to achieve the condition you described, which I think would be hard, but not impossible, to achieve.

Senator MATTINGLY. It's not going to be impossible, because I intend to hold hearings this year on the subcommittee that I chair, Congressional Operations and Oversight, because I am an optimist. I think we can find a better factor than the current CPI, because everybody admits that it's incorrect, and it's costing the Government tremendous billions of dollars yearly.

There's no way you, as an OMB Director, can ever balance that budget until those are controlled. Isn't that correct?

Mr. STOCKMAN. That and many other entitlement factors. That's correct.

Senator MATTINGLY. Right. And I intend to help you out in that area.

TAX POLICY AND ECONOMIC GROWTH

Now, second, there is the underlying argument that continually goes on, of how this country is going to raise revenues to the Federal Government. And there's two battles, you know. There is the battle of the people that don't know any better; that means they want to raise taxes.

Don't you agree that we should try to let this program of incentives go into effect, to create the growth in the economy?

And isn't it true that the growth will create the jobs, which will create a broader tax base, which indeed will create more revenues to our cities, counties, State, Federal Government?

Mr. STOCKMAN. That's precisely right. And I keep cautioning people that say, "Well, solve this deficit problem by canceling the tax cut." But if you do that, you're going to have to change your economic projections as well. You're going to have to show lower growth, much higher inflation, continued weakness in the economy; and that feeds back into the projections and puts the deficit back on the table.

What you are saying is precisely right and it goes back to the point that I made earlier: there aren't any easy solutions. Once you go beyond simply totaling up numbers, and get down to more refined reasoning and calculations, you will find that some of these 2-day solutions that sound at first so simple are not going to hold up for very long.

Senator MATTINGLY. There will be 535 other alternatives which you will expect. But maybe there will be things which I think could be valuable, and which you might be able to pick out from them.

STABLE MONEY GROWTH

One last thing. I noticed you were not here to debate Volckerism. But don't you agree that it would hurt—What do you think?—would it aid or would it hurt, to have a stable M_1 growth rather than an inconsistent growth of M_1?

Mr. STOCKMAN. Obviously it would help, but at the same time, we have to recognize that in the very short run, given the uncertainty in the money markets today, it's not easy to achieve. Certainly, anything the Fed can do to make the hand on the steering mechanism more steady, or the outcome more reliable, will help, because it will reduce uncertainty and thereby remove this great hesitancy that we see in the money markets today.

Senator MATTINGLY. Thank you.

ADMINISTRATION PROPOSAL TO TAKE PENNIES FROM THE JOBLESS

Representative REUSS. Mr. Stockman, in his recent column in the Wall Street Journal, Norman Miller, the Washington bureau chief, said, and I quote: "In perhaps the meanest line in the budget, the administration proposed to take pennies from jobless people, by rounding weekly unemployment compensation checks down to the next lower whole dollar."

Is that true?

Mr. STOCKMAN. Congressman Reuss, last year the Congress rounded down to the next lower whole dollar social security checks. And as a result of that precedent for the elderly of this country, a policy that was presumed to be certainly not harmful to anyone, but a way of saving on the margin. We, following the lead of the

Congress, have applied that same principle to the other Federal benefit payment programs.

Representative REUSS. Well, in my view, last year's Congress was one of the worst in history. So, I wouldn't want to generalize from what they did.

I will just give you my view, which is that rounding benefits of poor people down to the lower whole dollar isn't nice. And really, a government of the people shouldn't do it. And to the extent that Congress is a party to this act of meanness, shame on Congress.

I know that Senator Proxmire has several questions, but he is on the floor. And I think it would be unfair to ask you to stay longer. If he submits his questions, I know that you will be willing to answer them for the record.

Mr. STOCKMAN. Most certainly.

Representative REUSS. Let me say that you, as always, have been an excellent witness. We enjoyed having you with us, and I hope you don't think that we have been too awful.

Mr. STOCKMAN. Thank you.

Representative REUSS. We now stand in recess until next week.

[Whereupon, at 5:15 p.m., the committee recessed, to reconvene at 10 a.m., Thursday, February 18, 1982.]

APPENDIX

UNITED STATES DEPARTMENT OF
COMMERCE NEWS
WASHINGTON, D.C. 20230

INTERNATIONAL TRADE ADMINISTRATION

U.S. TRADE AND INVESTMENT MISSION TO AFRICA
January 8-21, 1982

Mission Business Accomplishments

I. NIGERIA

(Agro-Tech International)

- Proposed high-yield cassava (100,000 tons per year on 12,000 acres) animal feed processing plant in Nigeria (estimated value is $10-12 million).

- Signed joint venture agreement for a breeder chicken farm to produce 50 million chicks ($4-5 million).

(Read Steel Products)

- Will be signing in two weeks contract for $400,000 grain storage project.

(Rice Council for Market Development)

- Invited Ministers from Ivory Coast and Nigeria to U.S. for tour of rice-producing regions.

(OPIC)

- OPIC President Nalen signed feasibility study financing agreement ($130,000) for potential investment of $22 million for a hog breeding farm.

- OPIC signed an agreement for pre-investment assistance ($10,000) to the Prince Company. It is exploring a possible rice-based pasta plant in Lagos for a potential $15 million investment.

(Air Products and Chemicals)

- Is actively pursuing bid for Bonny LNG project in Nigeria.

(Fru-Con International)

- Final stages of consideration for $100 million dam and water treatment project in Nigeria.

(J. D. Allen Industries)

- Negotiating major joint-venture for 5 off-shore jack-up drilling rigs and 8 land rigs. Includes management contract.

(T-CAS America)

- Contract to be signed for weather radar system for Port Harcourt Airport ($6 million).

II. CAMEROON

(Air Products and Chemicals)

Has submitted bid for LNG process technology and heat exchangers.

(Agro-Tech International)

- Feasibility study in Cameroon for integrated broiler operation producing 3 million day-old chicks per year (processing plant estimated $4-5 million).

(Read Steel Products)

- Submitted proposal in Cameroon for $500,000 grain storage facility.

(Sherman R. Smoot)

- Tentative agreement for partnership in housing and commercial construction in Cameroon with potential value of $7.5-10 million (depending on local construction costs).
- Land made available for two hotels and 40-bed medical center. (Value included in above estimate.)

(J. D. Allen Industries)

- Within 60 days expect a joint venture for oil field servicing equipment plus other major projects in construction.

III. IVORY COAST

(Charles T. Main)

o Verbal contract for several small industrial plants in Ivory Coast with industrial development group. (To be confirmed in writing.) Estimated value is $1 million for feasibility study; engineering and design could increase value to $2-3 million.

(Gateway International)

o Has already sent a representative back to Abidjan to discuss oil pollution clean-up equipment.

IV. MOROCCO

(Agro-Tech International)

o Signed feasibility contract ($75,000) for integrated poultry operation (OPIC supported) in Morocco for potetial investment of $5 million.

(Sherman R. Smoot)

o Partnership for export-import operation (rugs, brass, copper, ornamental woodworking) with profits reinvested in Morocco for housing construction.

(Systems Architects)

o Systems Architects will propose a feasibility study to establish a nationwide data communications utility ($250,000-$500,000).

WEST AFRICA

(Rice Council for Market Development)

o Likely will establish Rice Council office in West Africa.

PARTICIPANTS IN AFRICAN TRADE AND INVESTMENT MISSION JAN. 8-22, 1982

AGRICULTURAL COMMODITIES

Company	Representative
American Soybean Association Washington, D.C.	Dr. Kenneth L. Bader Chief Executive Officer
Louis Dreyfus Corporation Stamford, Conn.	Harold E. House Executive Vice President
Rice Council for Market Development Houston, Texas	Bill Goldsmith Executive Vice President
Tidewater Grain Company Indianapolis, Ind.	Samuel M. Harrell Chairman of the Board
U.S. Wheat Associates, Inc. Washington, D.C.	Milo Schanzenbach Secretary-Treasurer

AGRIBUSINESS

Company	Representative
Agro-Tech Int'l., Inc. Miami, Fla.	Dr. Francisco Hernandez President
Allis-Chalmers Corp. Milwaukee, Wis.	Frank E. Briber, Jr. Vice President
Mid-West Agricultural Trading Co. Bushnell, Ill.	Paul Fayhee Representative
Read Steel Products Birmingham, Ala.	Thomas W. Read Senior Vice President

CONSTRUCTION ENGINEERING, SUPPLIES & EQUIPMENT

Company	Representative
Air Products & Chemicals, Inc. Allentown, Pa.	James F. Dempsey Vice President, Int'l
Chas. T. Main Int'l., Inc. Boston, Mass.	George T. Lewis Group Vice President
Concrete Housing Int'l. Santa Rosa, Calif.	Amb. William Bradford Partner
Fru-Con International, Ltd. Houston, Texas	Alvan K. Gustafson Pres. & Chief Exec. Ofc.

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CONSTRUCTION ENGINEERING, SUPPLIES & EQUIPMENT

Company	Representative
Hagans Enterprises Washington, D.C.	Theodore R. Hagans, Jr. President
Louis Berger Int'l., Inc. East Orange, N.J.	Dr. Louis Berger Chief Executive Officer
Perini Corp. Framingham, Mass.	Joseph R. Perini Vice President
Raymond Int'l., Inc. Houston, Texas	Adm. James V. Bartlett Sr. Group Vice President
Sherman R. Smoot Co., Inc. Columbus, Ohio	Lewis R. Smoot, Sr. President

MINING & MINERAL EXTRACTION

Company	Representative
Ecology & Environmental, Inc. Buffalo, N.Y.	Amb. Armin H. Meyer Dir. of Int'l Relations
Gateway Int'l. Holdings, Inc. Washington, D.C.	Arthur P. Ismay President
J.D. Allen Industries Oklahoma City, Okla.	J. D. Allen President

TELECOMMUNICATIONS

Company	Representative
Motorola Schaumburg, Ill.	Joseph V. Guido Vice President
Systems Architects, Inc. Randolph, Mass.	George S. Pan President
T-CAS America, Inc. Falls Church, Va.	James S. Stotsky Chief Executive Officer
Unity Broadcasting Network, Inc. New York, N.Y.	Eugene D. Jackson President

1/8/82

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UNITED STATES DEPARTMENT OF
COMMERCE
NEWS
WASHINGTON, D.C. 20230

INTERNATIONAL TRADE ADMINISTRATION

CONTACT: Bonnie B. Whyte, (202) 377-3808

ITA 82-11

FOR IMMEDIATE RELEASE

SUCCESSFUL TRADE MISSION RETURNS FROM AFRICA

U.S. firms specializing in construction, transportation, communications, mining, and agriculture will see the chief benefits from the Reagan administration's trade mission to West Africa.

That's the message brought back by 70 members of a joint business-government delegation which returned last week from a 14-day effort to scout new business.

"The countries of West Africa want and need the help of U.S. businesses in building the modern foundations of strong economies," said Secretary of Commerce Malcolm Baldrige. "That means new opportunities for American business," he said.

He said results from the African trade mission were reflected in the numbers of contracts signed, and the new business leads established by members of the delegation.

Administration officials and 26 corporate executives met during the 14-days with trade and government officials of the Ivory Coast, Nigeria, Cameroon, and Morocco. This was the first trade mission of the Reagan administration and also the first to West Africa by such a high-level U.S. delegation.

Baldrige said the most pressing need by countries of the West African region was for construction of dams, communications facilitations, and railroads and build up their agricultural base so the people of those areas could become self-sufficient.

"These countries are building their infrastructure, improving their farming, and need the most basic of services and in which American firms specialize," he said.

Private businessmen accompanying the trade delegation said in a press conference Friday many sound business contacts were made by the mission, and several contracts were signed.

"We accomplished in 14 days what it would have taken two years and $2,000,000 to do by my company," said Dr. Francisco Hernandez, president of Agro Tech International of Miami, Fla.

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Hernandez said he signed several contracts for his firm to build plants producing up to 50 million chicks and 50 million broilers annually. He signed 5 joint venture projects in 3 countries during the mission.

Baldrige said all businessmen on the trade mission paid their own way, thus underwriting about 80 percent of the cost of the 14-day tour.

Baldrige and Agriculture Secretary John Block, also part of the delegation, said West African nations wanted to diversify their economic and political ties as developing countries, and look to the U.S. for technical help in development.

"Officials of these countries realize they must make their people self-sufficient, and their economic base solid as they develop national resources," said Baldrige.

"We tried to bring the buyer and seller together for their mutual benefit, because this Administration feels increased trade means jobs, U.S. jobs, not just jobs abroad," he said.

"We must all realize American business should not lead or follow the American flag, but must go abroad draped in the American flag," said Baldrige. "We did that on this mission and the immediate results are even better than we expected," he said.

Among the largest contracts signed by the trade mission were for construction of feed mills, grain storage bins, and poultry facilities.

"The agribusiness sectors of the American economy fared well on this trade mission," said Block, "because the ingenuity of the American farm economy is widely recognized as highly efficient and productive.

A total of 6 contracts for food production facilities were signed by members of the trade mission.

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1/22/82

UNITED STATES DEPARTMENT OF
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NEWS
WASHINGTON, D.C. 20230

INTERNATIONAL TRADE ADMINISTRATION

CONTACT: Malcolm Barr (202) 377-3142

ITA 82-7

FOR RELEASE SATURDAY,
JANUARY 16, 1982

U.S. FIRMS OPEN NEW LINKS WITH NIGERIANS ON TRADE VISIT

Major agricultural projects linking U.S. business with Nigerians are being initiated as a result of an American trade and investment mission now in Africa.

Large-scale poultry and hog operations, an animal feed development using cassava production, and a rice-based pasta project are moving ahead, according to Commerce Secretary Malcolm Baldrige.

In a report from the Nigerian capital of Lagos, he described these and other ventures of the business executives who are with him on the mission as evidence of the interest of the U.S. private sector in building up commercial ties with the developing nations.

Baldrige thus underscored the Reagan Administration's increased reliance on the participation of American private enterprise in its development aid programs for the Third World countries.

Baldrige and Agriculture Secretary John R. Block head a group of leaders of 26 U.S. companies or trade groups currently in Africa on a four-nation visit. The mission also includes top officials of the State Department, Agency for International Development, Export-Import Bank and the Overseas Private Investment Corporation.

Other projects actively discussed with Nigerians include a poultry equipment manufacturing plant, a small tractor assembly operation, construction of farm commodity storage bins, grain elevators and port equipment, and a petroleum drilling service unit.

-over-

The Overseas Private Investment Corporation, which provides investment insurance for U.S. firms in the developing nations, reported it has received applications from American companies for additional projects in Nigeria. It estimated that these covered investments in the range of $225 million.

Secretaries Baldrige and Block met with Nigeria's Vice President Alex Ekwueme, and had discussions with Nigeria's ministers of agriculture, mines and finance and other top officials, emphasizing particularly the U.S. commitment to the country's agricultural development. The U.S. will participate formally for the first time at the Kaduna Trade Fair; 50 U.S. firms are expected at this February event.

Earlier, in Abidjan, Ivory Coast, the mission met with President Felix Houphouet-Boigny. Members expressed support for the Ivorian free market economy and noted the stability and growth in that country and its open door for American ivestment.

The mission is now in Yaounde, Cameroon. The members meet Monday, Jan. 18, with President Ahmadou Ahidjo. Before concluding its work Jan. 21, the mission will also visit Morocco.

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UNITED STATES DEPARTMENT OF
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WASHINGTON, D.C. 20230

INTERNATIONAL TRADE ADMINISTRATION

CONTACT: Bonnie B. Whyte, (202) 377-3808 ITA 81-211

FOR IMMEDIATE RELEASE

HIGH-LEVEL U.S. TRADE AND INVESTMENT MISSION TO AFRICA SUPPORTS PLEDGE TO DEVELOPING COUNTRIES

The White House announced today a joint business-government mission will be sent to Africa in January as the Reagan Administration's first follow-up on pledges made at the Cancun economic summit talks.

The high-level trade and investment mission will be headed by Commerce Secretary Malcolm Baldrige and Agriculture Secretary John R. Block. The two-week mission will include chief executives of 30 American firms interested in expanding trade with the African nations of Cameroon, Ivory Coast, Nigeria and Morocco.

Officials of the State Department, Agency for International Development (AID), the Export-Import Bank, and the Overseas Private Investment Corporation will accompany Baldrige and Block.

White House officials said the Jan. 8-21 mission will focus on increasing trade in five product lines -- farm commodities, agribusiness, construction engineering equipment and supplies, telecommunications equipment, and mining and mineral extractions equipment.

Only 4 percent of U.S. total exports now go to Africa, and U.S. investment in Africa is only 3.2 percent of total U.S. foreign investment.

"At the Cancun summit talks, President Reagan renewed America's commitment to help developing countries achieve self-sustained growth patterns, and this trade mission is designed to spur that effort," Baldrige said.

In addition to Baldrige and Block, government members of the mission will include Lionel H. Olmer, under secretary of commerce for international trade; [redacted] William H. Draper, III, president and chairman of the Export-Import Bank; Craig A. Nalen, president and chief executive officer of the Overseas Private Investment Corporation; and Elise duPont, assistant administrator, Bureau of Private Enterprise, AID.

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11/25/81

UNITED STATES DEPARTMENT OF
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NEWS
WASHINGTON, D.C. 20230

INTERNATIONAL
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ADMINISTRATION

CONTACT: William Scouton, (202) 377-3259

FOR IMMEDIATE RELEASE

CALIFORNIA COMPANY EXPLORES
BUSINESS OPPORTUNITIES
DURING MISSION TO AFRICA

Concrete Housing International, Inc., of Fairfield, Calif., is moving forward with joint ventures in Ivory Coast and Cameroon that it explored on a recent U.S. Trade and Investment Mission to Africa.

The company, represented by Ambassador William G. Bradford, a partner, also investigated business opportunities in Nigeria and Morocco during the two-week trip.

The 70-member joint business-government mission, headed by Secretary of Commerce Malcolm Baldrige and Secretary of Agriculture John R. Block visited the African nations of Ivory Coast, Nigeria, Cameroon and Morocco Jan. 8-21. It was the largest U.S. trade and investment mission ever to visit Africa, and the first of the Reagan Administration.

Executives of 25 companies from 17 states and the District of Columbia took part in the mission. They represented agribusiness; agricultural commodities; construction engineering supplies and equipment; telecommunications; and mining and minerals extraction.

"The countries of Africa want and need the help of U.S. businesses in building the modern foundations of strong economics," Baldrige said. "That means new opportunities for American business."

The mission was a follow-up to pledges made at the Cancun economic summit talks last October by President Reagan. The President stated at Cancun that economic freedom and private initiative are the keys to self-sustaining growth in the developing nations.

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UNITED STATES DEPARTMENT OF
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WASHINGTON, D.C. 20230

INTERNATIONAL TRADE ADMINISTRATION

CONTACT: William Scouton, (202) 377-3259

FOR IMMEDIATE RELEASE

MASSACHUSETTS CONSTRUCTION FIRM FINDS BUSINESS OPPORTUNITIES DURING MISSION TO AFRICA

Perini Corporation of Framingham, Mass., is pursuing several construction opportunities in Africa that it explored on a recent U.S. Trade and Investment Mission to that continent.

The firm is investigating the long-term possibilities in Ivory Coast of developing hydroelectric power and a major bridge. It also is following up on two large hospital projects and a railroad extension in Cameroon and the early stages of hydrodams, port expansion and railroad extension in Morocco. In Nigeria, Perini is making further inquiries about a wide range of development projects.

Joseph R. Perini, senior vice president and treasurer, represented the firm on the trip.

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INTERNATIONAL TRADE ADMINISTRATION

CONTACT: William Scouton, (202) 377-3259

FOR IMMEDIATE RELEASE

PENNSYLVANIA COMPANY
IMPROVES PROSPECTS
ON U.S. MISSION TO AFRICA

Air Products and Chemicals, Inc., of Allentown, Pa., improved its prospects for obtaining a contract to provide technology and heat exchangers for a liquified natural gas project in Cameroon during a U.S. Trade and Investment Mission to Africa.

James F. Dempsey, vice president-international of the firm, said that, as a result of the mission, Air Products is in much better position to put together the competitive financing package it needs to secure the contract.

Dempsey, who took part in the Mission, also found interest in Africa in his company's waste-water technology and water purification systems.

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CONTACT: James F. Rourke, (202) 377-2253

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ALLIS-CHALMERS FINDS AFRICAN TRADE POTENTIAL

Allis-Chalmers Corp. of Milwaukee has found strong possibilties for U.S. participation in hydro-electric power projects in Cameroon and Morocco as a result of a recent U.S. trade and investment mission to Africa.

Company vice president Frank E. Briber, Jr. represented Allis-Chalmers on the trip.

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STAMFORD EXECUTIVE
ENDS AFRICA MISSION

Louis Dreyfus Corp., of Stamford, Conn., intends to increase shipments of U.S. corn and soybean meal to the Ivory Coast after returning from a recent U.S. Trade and Investment Mission to Africa.

The firm's executive vice president, Harold E. House, represented Dreyfus on the trip.

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U.S. WHEAT GROWERS GROUP
UNCOVERS NEW MARKETS DURING
W. AFRICAN TRADE MISSION

U.S. Wheat Associates Inc., overseas market development arm of the U.S. wheat industry, uncovered significant new potential markets for its members as a result of participating in a U.S. Trade and Investment Mission to Africa sponsored by the U.S. Department of Commerce.

Milo Schanzenbach, secretary-treasurer, who represented the group, also noted that the trip helped promote good will towards U.S. growers and their product.

U.S. Wheat Associates is a Washington-based organization with state member groups including South Dakota, North Dakota, Washington, Oregon, Montana, Idaho, Nebraska, Minnesota, Oklahoma, Kansas, Texas, Wyoming and Colorado.

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ALABAMA COMPANY
SUCCEEDS ON U.S.
MISSION TO AFRICA

Read Steel Products of Birmingham, Ala., is preparing to sign a $400,00 contract for a grain storage project in Nigeria after returning from a U.S. Trade and Investment Mission to Africa.

The firm also has submitted a proposal for a $500,000 grain storage facility in Cameroon and has excellent business leads in Ivory Coast and Morocco.

Senior vice president Thomas W. Read represented the Birmingham company on the mission

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FOR IMMEDIATE RELEASE

RICE COUNCIL SEEKS TRADE CONTRACTS IN WEST AFRICA

The Rice Council for Market Development is seeking to develop trade relationships with the West African countries of Ivory Coast, Nigeria, and Cameroon in the hope of making sales contracts in those countries.

Bill Goldsmith, executive vice president of the council, says the organization, which represents rice growers of Louisiana, Texas, Mississippi, and Arkansas, will follow up with its membership to pursue tentative trade contracts and develop an import or agency relationship.

Goldsmith was one of the American executives who recently made a trip to African countries in the interest of trade and investment promotion. Invitations have been extended to ministers of the Ivory Coast and Nigeria to visit Washington and the U.S. rice-producing regions.

Information relating to contacts made during the course of the mission, Goldsmith says, will be distributed to Council members in the hope that follow-up action will be taken and trade relationships established. The Council is considering the possibility of establishing an office and representation in Africa.

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MISSION TO AFRICA
BRINGS SALES LEADS

The U.S. Trade and Investment Mission to Africa generated so many sales leads that, "if no sales result, the fault clearly will be our own," says Paul Fayhee of Midwest Agricultural Trading Co., Bushnell, Ill.

Fayhee represented Midwest Agricultural on the trip.

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FALLS CHURCH FIRM EXPECTS MAJOR NIGERIAN CONTRACT

An engineering and construction firm located in Falls Church, Va., today reported that it expects a major sale as a result of participating in a U.S. Trade and Investment Mission to Africa sponsored by the U.S. Department of Commerce.

During the mission, T-CAS America, Leesburg Pike, consulted with Nigerian government officials on several projects, including a weather radar system that would eventually encompass all of Nigeria. The company expects over the next several years to obtain contracts worth several million dollars.

"The mission helped us make important contacts," James S. Stotsky, chief executive officer, said, "and we are delighted with the results."

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FOR IMMEDIATE RELEASE

ILLINOIS COMPANY FINDS
BUSINESS OPPORTUNITIES
ON AFRICAN TRADE MISSION

Motorola, Inc. of Schaumburg, Ill., is working on several proposals to sell communications equipment in Ivory Coast after returning from the U.S. Trade and Investment Mission to Africa.

The firm found excellent prospects in Nigeria for private sector communications. It will sponsor a seminar in that country within six months on technical spectrum management for industry and the Ministry of Communications.

Motorola also is looking into sales prospects in Cameroon in connection with port expansion, railroad extension, highway construction and private communications.

Joseph V. Guido, vice president of Motorola's Communications International Group, represented the company in Africa.

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MASSACHUSETTS
EXECUTIVE ENDS
AFRICA MISSION

Systems Architects of Randolph, Mass., whose president, George S. Pan, has just returned from a U.S. Trade and Investment Mission to Africa, will propose a feasibility study to establish a nationwide data communications utility in Morocco.

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FOR IMMEDIATE RELEASE

HOUSTON EXECUTIVE
RETURNS FROM U.S.
MISSION TO AFRICA

Fru-Con International of Houston is in the final stages of consideration for a multimillion dollar project in Nigeria after returning from a U.S. Trade and Investment Mission to Africa.

Company president Alvan K. Gustafson represented the Texas company on the mission. Selected by his peers as the business spokesman for the mission, Gustafson said the private sector participants would form their own follow-up group to work with the Commerce Department. In a Washington press conference, he said he was impressed with the Reagan Administration's efforts to help business export in developing countries.

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HOUSTON FIRM UNCOVERS MAJOR BUSINESS POTENTIAL DURING W. AFRICAN MISSION

A major international construction, engineering and manufacturing company located in Houston, Texas, today reported that it uncovered several projects of major potential as a result of participating in a U.S. Trade and Investment Mission to Africa sponsored by the U.S. Department of Commerce.

Admiral James V. Bartlett (Ret.) who represented Raymond International Builders, Inc., said that the company will compete for such projects as development of ports and harbors, fabrication and installation of offshore oil and gas platforms, hydroelectric power development and minerals extraction and development.

"Our participation in the trip was highly worthwhile," Admiral Bartlett said.

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DULLES AIRPORT COMPANY
REPORTS AFRICAN MISSION
HAD IMPORTANT RESULTS

Gateway International Holdings, Inc., Dulles International Airport, today reported results from its participation in a trade and investment mission to West Africa sponsored by the U.S. Department of Commerce.

During the mission, the company began consultations with Ivory Coast government officials about providing oil pollution equipment. Gateway International executives have returned to the Ivory Coast to continue the discussions.

"We are very optimistic as to their outcome," Arthur P. Ismay, Gateway president, said. "The mission helped us make high level contacts that would have been difficult for us to achieve on our own."

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FOR IMMEDIATE RELEASE

J. D. ALLEN NEGOTIATING OIL PROJECTS IN AFRICA

J. D. Allen Industries, Inc., Oklahoma City, Okla., is negotiating a number of projects in West Africa, including negotiations for a major joint-venture for drilling rigs in Nigeria.

J. D. Allen, chairman, says the firm is also negotiating a joint venture for oil field services and supplies in Cameroon. In Morocco, after the National Oceanic and Atmospheric Administration conducts a marine study, a possible fishing and processing operation may be developed.

J. D. Allen Industries Inc., also has affiliate offices in London, Zurich, and Hong Kong.

Mr. Allen was one of the American executives who recently made an extensive trip in Africa in the interest of trade and investment promotion.

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SOYBEAN GROUP UNCOVERS
MAJOR EMERGING MARKETS
THROUGH W. AFRICAN TRIP

The American Soybean Association has uncovered important emerging markets for its industry and its members as a result of participating in a U.S. Trade and Investment Mission to Africa sponsored by the U.S. Department of Commerce.

Dr. Kenneth L. Bader, chief executive officer of the St. Louis, Mo., based group, said: "Our industry will reap substantial benefits from this mission.

"We foresee dramatic increases in the markets we explored. We are now alert to the need to help some of these countries overcome certain problems of storage, processing and utilization, so that the sales can be made by U.S. firms rather than by other countries."

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BUFFALO FIRM FINDS NEW MARKETS BY PARTICIPATING IN TRADE MISSION

A Buffalo, N.Y., firm has found important new markets for its consulting services as a result of participation in a U.S. Commerce Department Trade and Investment Mission to Africa.

Ambassador Armin H. Myer, director of international relations, Ecology and Environment, Inc., who represented the company on the mission, said that the four countries visited by the mission recognize the importance of fighting pollution and that his company will explore opportunities to serve as a consultant in pinpointing and identifying pollution problems and solutions.

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MIAMI COMPANY
REPORTS MAJOR SALES
AFTER AFRICAN MISSION

A leading Miami company Agro-Tech International, has reported that it has achieved significant sales through participation in a U.S. Trade and Investment Mission to Africa sponsored by the U.S. Department of Commerce.

"We accomplished in 14 days what would have taken two years and $2,000,000 to do by my company," said Dr. Francisco J. Hernandez, president of Agro Tech International of Miami, Fla.

Hernandez said he signed several contracts for his firm to build plants producing up to 50 million chicks and 50 million broilers annually. He signed 5 joint venture projects in 3 countries during the mission.

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BOSTON ENGINEERING FIRM
FINDS OPPORTUNITIES IN
AFRICA ON TRADE MISSION

Charles T. Main International, Inc., of Boston, Mass., a large consulting engineering firm, obtained a verbal contract to design several small industrial plants and facilities in Ivory Coast during a U.S. Trade and Investment Mission to Africa.

George T. Lewis, Jr., group vice president of the firm, said that top-level contacts made during the mission gave him a comprehensive rundown of the needs of four African for developing hydroelectric plants, rural electrification and irrigation.

The firm is doing follow-up work on two major projects in Africa that may lead to contracts within the next three months.

The mission was successful in giving us the "who, where, what and when" in doing business in Africa, Lewis said.

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FOR IMMEDIATE RELEASE

SHERMAN R. SMOOT CO. EXPLORING TRADE PROSPECTS IN AFRICA

The Sherman R. Smoot Co., Inc., Columbus, Ohio, has made tentative agreements with partners in Cameroon for a housing development, and for construction of two hotels and a 40-bed medical center for which land has been made available.

The company has made similar arrangements with partners in Morocco for establishment of an export-import operation, profits from which would be reinvested in Morocco for housing construction.

Lewis R. Smoot, Sr., president of the company, says that completion of these agreements will depend on feasibilty studies and the arrangement of financing. The Cameroon and Morocco partners are expected to visit the United States in coming months to work out further details.

Mr. Smoot was one of the executives comprising a recent trade and investment mission to West Africa.

The agreements made by Mr. Smoot on this trip were among the many achievements of this mission, which was the largest U.S. trade and investment mission ever to visit Africa, and the first of the Reagan Administration.

The 70-member joint business-government mission, headed by Secretary of Commerce Malcolm Baldrige and Secretary of Agriculture John R. Block visited the African nations of Ivory Coast, Nigeria, Cameroon and Morocco Jan. 8-21.

Executives of 25 companies from 17 states and the District of Columbia took part in the mission. They represented agribusiness; agricultural commodities; construction, engineering supplies and equipment; telecommunications; and mining and minerals extraction.

"The countries of Africa want and need the help of U.S. businesses in building the modern foundations of strong economies," Baldrige said. "That means new opportunities for American business."

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THE 1982 ECONOMIC REPORT OF THE PRESIDENT

THURSDAY, FEBRUARY 18, 1982

CONGRESS OF THE UNITED STATES,
JOINT ECONOMIC COMMITTEE,
Washington, D.C.

The committee met, pursuant to recess, at 10:05 a.m., in room 2128, Rayburn House Office Building, Hon. Henry S. Reuss (chairman of the committee) presiding.

Present: Representatives Reuss, Mitchell, Richmond, and Rousselot; and Senator Sarbanes.

Also present: James K. Galbraith, executive director; Louis C. Krauthoff II, assistant director; Betty Maddox, assistant director for administration; and William R. Buechner, Mark R. Policinski, and Richard Vedder, professional staff members.

OPENING STATEMENT OF REPRESENTATIVE REUSS, CHAIRMAN

Representative REUSS. Good morning. The Joint Economic Committee will be in order for another session of its annual hearings on the President's Economic Report.

POLICIES OF PRESIDENTS REAGAN AND HOOVER COMPARED

With the prime rate up again, the level of industrial production, of housing and the stock market down again, we meet today to assess the 1982 Economic Report of the President. It is 50 years after the onset of the Great Depression and there are certain resemblances between Herbert Hoover and Ronald Reagan. Confronted with 10 million unemployed in 1932, the Hoover administration was confident that prosperity was just around the corner. Confronted by 10 million unemployed today, Ronald Reagan, while viewing "the current recession with concern," says he's "convinced that our policies, now that they are in place, are the appropriate response to our current difficulties," Economic Report of the President, page 9. The economic advisers add that "The current recession is expected to end early in 1982, followed by a resumption of growth my midyear," ibid., page 209.

TRICKLE DOWN POLICIES

The policies referred to by the President are high interest rates to fight inflation, huge tax cuts for the affluent to fight unemployment, and drastic budget retrenchment for the needy to teach them self-reliance, the politics of trickle down, the politics of greed.

Herbert Hoover also believed deeply in trickle-down economics. As he said: "The sole function of government is to bring about a condition of affairs favorable to the beneficial development of private enterprise." Aided by his Secretary of the Treasury, Andrew Mellon, huge tax cuts were given the wealthy. The depression ensued. As banker Frank D. Vanderlip said, to explain the Depression, "Capital kept to much and labor didn't have enough to buy its share of things."

In his acceptance speech at the Chicago convention in 1932, Franklin Roosevelt met the trickle-down theory head on when he said: "The theory of government that helps a favored few and hopes that some of their prosperity will leak through to labor, to the farmer, to the small businessman, has been discredited."

STATE AND LOCAL GOVERNMENTS TO BE RESPONSIBLE FOR THE NEEDY

A second salient feature of President Reagan's economic program is his belief that the problems of the unemployed and the needy can best be handled by private charity and by State and local government. If only each church in America would adopt 10 poor families, he says, "our welfare problem would be solved." Under the New Federalism, aid for families with dependent children and the food stamp program are to be turned over to state and local government.

Herbert Hoover, confronted with his 10 million unemployed 50 years ago, also preferred rugged individualism to Federal action. Mr. Hoover said: "This is not an issue as to whether people shall go hungry or cold in the United States. It is solely a question of the best method by which hunger and cold shall be prevented. It is a question as to whether the American people, on one hand, will maintain the spirit of charity and mutual self-help through voluntary giving and the responsibility of local government, as distinguished, on the one hand, from appropriations out of the Federal Treasury for such purposes."

RETURN TO THE GOLD STANDARD

The third, and final, link between the economics of Mr. Reagan and the economics of Mr. Hoover was put into place only last week. Before the Gold Commission, Treasury Secretary Regan and Economic Advisers Weidenbaum and Jordan, members of the Gold Commission, chose this time of crisis to bring gold to the rescue. These gentlemen proposed the creation of a gold coin to be sold by the U.S. Treasury and to be exempt from all capital gains taxes, thus giving gold speculators an opportunity not available to them in the Kruggerand and the Maple Leaf.

The beleaguered Herbert Hoover also viewed gold as the rescuer of his collapsed economy, declaring that gold is a metal "enshrined in human instincts for over 10,000 years." He boasted as having saved the gold standard 50 years ago, in early 1932, saying, "Never was our Nation in greater peril."

So runs the parallel between Reagan economics and Hoover economics. But one should not impute evil either to President Hoover or to President Reagan.

President Hoover was a poor boy fishing for perch with a bent pin in an Iowa stream. In his early years, his outlook was liberal, his devotion to civil liberties intense, his high ideals everywhere apparent. But later on, he came under different influences. The eminent Republican editor from Kansas, William Allen White, reporting in 1932, noted that Mr. Hoover complained privately of the greed of the millionaires who were running the country, but added, "But because he had worked for 30 years with men of wealth, he could not publicly scold a million dollars, much less a hundred million."

Ronald Reagan also started life as a poor boy. His father knew unemployment during the Depression and finally got a job through FDR's New Deal. Four times, in 1932, 1936, 1940, and 1944, Ronald Reagan voted for Roosevelt. He was the fighting head of his labor union and a leader of progressive veterans. But 30 years ago, he went to work as a publicist for General Electric, and since then, like Mr. Hoover, he has kept the company of millionaires.

Mr. Hoover, meet Mr. Reagan.

We will now hear of the President's economic program from Mr. Weidenbaum, Mr. Jordan, and Mr. Niskanen.

Congressman Mitchell, did you have an opening statement?

Opening Statement of Representative Mitchell

Representative Mitchell. Yes, thank you. It is certainly not as eloquent as yours. I just wanted to refer to an old sociological theory of propinquity. The basic assumption of the theory is that the closer you are physically to people, the more frequently you are close physically to people, the better will become the interpersonal relationships.

PICTURE OF HERBERT HOOVER

I would request that this be moved away just a little bit [indicating] because it flies in the face of that sociological theory of propinquity. So if one of the staff would just, so I can see in that direction, just give me a little more distance. I'd appreciate it. [Laughter.]

IMPACT OF THE RECESSION

What can I say in an opening statement except that, as I travel around this country and as I talk with people of all persuasions at all socioeconomic levels, they're being devastated. The small business community, the small businesses around this Nation, are just on the phone or writing to me every day, saying, we are being destroyed. The unemployment lines grow longer each day.

One day this week I visited a senior citizens home and went door-to-door talking to the people and in the elevator one woman said to me, "I'm thinking about killing myself, because if, indeed, this man continues to threaten my retirement benefits, I'm going to have nothing left and I should die."

I'm going to tell you that it's the economic policies, coupled with an attitude toward those of us who are black, brown, and Hispanic, these two things are creating an atmosphere of absolute despair.

REAGAN POLICY TOWARD AFFIRMATIVE ACTION

The administration has made it clear that it has no patience with, nor support for, affirmative action. Now as our minority people go into the various agencies of government to secure certain benefits that they are entitled to under the law, lower level bureaucrats are telling them that this is a new ballgame and you're not a part of it, even though there's a law.

And I think that that kind of contumacious climate obviously is traceable to perceptions or misconceptions being the kindest thing, of statements that are eminating from the White House and from the hierarchy that there is in the White House.

Just one last brief statement, Mr. Chairman. People often accuse me of being too outspoken and—not radical—but liberal. And maybe I am. I am a liberal. I can't help it. I always will be. But my concern it that every people, I don't care who they are, every group has a toleration level for frustration. And I greatly fear that in our cities, with unemployment reaching the astronomical proportions that it is, with the despair that is just racking our communities, I'm afraid that people are being pushed to their toleration level for frustration. And the sad thing is they see no immediate sign, no sign that this situation will be cured at any time in the near future.

I respect the Office of the President. I disrespect the policies that are being pursued, both in terms of economics and in terms of civil rights and civil liberties. And I am grossly, grossly concerned that a large segment of our American population is now reaching the point where it is so despairing, so bereft of hope, that is might initiate untoward activities which I don't want to see happen. I dont want that to happen. I've lived through that. But, my God, somebody, somewhere has got to become aware of the fact that you cannot put people in this crucible. You cannot continue to turn the screw on them and deny them jobs, threaten whatever programs they have, and at the same time, evidence an attitude of content toward the minorities of this Nation.

Thank you for letting me make my opening statement.

Representative REUSS. Thank you Representative Mitchell. Our colleague, Congressman John Rousselot of California, has an opening statement, which I'll be glad to read.

OPENING STATEMENT OF REPRESENTATIVE ROUSSELOT

Representative REUSS [reading]. "I'm delighted to welcome you, gentlemen, to today's JEC hearing and look forward to your testimony. You have just issued your first annual report and it is an impressive document. Unlike previous reports that have been obsessed with short-run problems dealing with the business cycle, your report deals in an intelligent fashion with the long-run problems facing the economy—excessive inflation, too much Government spending, oppressive Government regulation, and inadequate capital formation and savings. These problems reflect monetary growth that over the past decade has been too excessive and erratic, and a tax system that in the past has penalized productive activities while encouraging less productive ones.

"I concur with your view that the 1981 tax cut is an important step in relieving our problems and that Government intervention in the economy, more often than not, tends to destablize it and lower the rate of economic growth. I agree with your arguments in favor of reducing the regulatory burden that too often confers few benefits on society, but involves enormous costs. I also agree with your call for steady but moderate amounts of monetary growth.

"In short, generally I like what you have said in your annual report and look forward to your testimony and your comments."

Congressman Richmond, did you have any opening statement?

Representative RICHMOND. No, Mr. Chairman.

Representative REUSS. All right, Mr. Weidenbaum, we're delighted to have you. Your prepared statement will be received in full into the hearing record, as is the Economic Report of the President itself,[1] and would you proceed in whatever way is congenial to you.

STATEMENT OF HON. MURRAY L. WEIDENBAUM, CHAIRMAN, COUNCIL OF ECONOMIC ADVISERS, ACCOMPANED BY WILLIAM A. NISKANEN, MEMBER; AND JERRY L. JORDAN, MEMBER

Mr. WEIDENBAUM. Thank you, Mr. Chairman, and members of the committee. With the inflation rate down again, housing permits up, home sales up, durable good orders up, the leading indications up, and with the employment ratio at historical high levels, I am pleased to appear before this committee this morning to discuss the 1982 Economic Report of the President and the report of the Council of Economic Advisers. I am accompanied by my fellow Council members, Mr. Jerry Jordan and Mr. William Niskanen.

While there are many important and interesting matters covered in these two documents, I would like to deal with just the critical, and the key issues this morning.

ACHIEVEMENTS OF THE REAGAN ADMINISTRATION

First of all, I thank the chairman for the history lesson. I would suggest that some modern history is also instructive. For example, I noted that at the beginning of the previous administration, the prime interest rate was 6¾. At the end of the previous administration, it was 21½.

Representative REUSS. For which sins there was a change of administration. [Laughter.]

Mr. WEIDENBAUM. I am certainly not going to enter a theological discussion——

[Laughter.]

Mr. WEIDENBAUM [continuing]. But point out that our sense of direction, I think, is a bit better. The prime rate is not as low as you or I would like, but considerably lower than it was at the beginning of this administration. I notice that the Consumer Price Index rose from a 5-percent rate in January of 1977 to the double-digit rate in January 1981, and, of course, as I point out, we have turned around that escalating double-digit inflation rate.

In terms of the unemployment rate and especially the high unemployment rate that has characterized our central cities and our

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[1] The 1982 Economic Report of the President may be found in the committee files.

minorities for some time, I, not without some sadness, report that despite the tens of billions of dollars of well-intentioned outlays, on the part of so many Federal agencies during the 1960's and during the 1970's, those unemployment rates in our minorities, in our central cities, expanded and grew during that period.

Therefore, it is quite clear, in my judgment, Mr. Chairman, members of the committee, that the status quo that we inherited patently didn't work. And, very frankly, I feel no compulsion to defend those well-intentioned, but obviously ineffective, programs of the past.

NEED TO REVISE GOVERNMENT ROLE IN ECONOMY

As Mr. Rousselot said in his opening statement, this is a long-term economic program, and it's in that spirit that my colleagues and I have written the Council's annual report. Throughout the short Presidential statement which leads off that report, one fundamental thing is clear—the need to redefine the role of the Federal Government in our economy.

As the President has made clear on numerous occasions, his economic program is designed to deal with the long-run problems which have been afflicting the U.S. economy for a decade and more: High inflation; low saving and investment; stagnant productivity; and insufficient jobs.

Many of these problems, in our view, are connected with poor Government policies of the past, policies which sought to involve the Federal Government at both the macro and the micro level.

This administration has taken a fundamentally different approach. As the President's report states: "Economic policy must seek to create a climate that encourages the development of private institutions conductive to individual responsibility and initiative." While there is a range of appropriate activities for the Federal Government, we believe that if we are to have a healthy and growing economy, the Federal Government's role will have to be considerably changed from the past.

SUMMARY OF TOPICS IN THE ECONOMIC REPORT

I would now like to summarize the key statements made in the Council's report as they appear in chapter 1, and I will just give the highlights.

First of all, production and employment in 1982 are expected to increase at a moderate rate in the second quarter and at a brisk pace through the rest of the year, probably in excess of a 5-percent annual rate. Inflation is likely to continue to decline and to average about 7 percent for the year, with further progress in 1983 and beyond.

I should like to remind the chairman and members of the committee that just one year ago, inflation was the No. 1 problem on the mind of the American public. Every public opinion poll demonstrated that. And therefore, the accomplishment in reducing that inflationary situation, I think deserves some attention.

We believe that the policies currently in place—recent and prospective tax cuts, a lower rate of inflation, and a continuing advance in defense activity—provide the basis for a strong second half.

The second point, prospective budget deficits, reflect the effects of the recession, as well as lower inflation, tax law changes, and the need to rebuild our defenses.

The third point, that the Fed's targets for money growth are not compatible with the vigorous upturn in economic activity we envisioned later in 1982, are unjustified. It appears, some suggest, that the upturn will lead to a sharp upswing in interest rates and choke off recovery. This sentiment, while understandable on the basis of previous history and policies, is unjustified in light of current policies and the administration's determination to carry them through.

Point four, the economy in 1981 reflected the policies of the past and the transitory effects of the necessary changes in those policies. Since the administration's economic policies are designed to increase long-term economic growth and to reduce inflation, they were not expected to have immediate favorable impact.

The primary policy element that affected economic conditions in 1981 was the reduction of the growth in the money supply relative to the record high rate of 1980.

Point five, the speed with which the economy adjusts to the administration's policies is closely connected to the extent to which individuals believe the administration will maintain, unchanged, its basic approach to personal and business taxation, federal spending and regulation, and monetary policy.

Point six, the greater the degree of cooperation between the administration, the Congress, and the Federal Reserve in continuing to support the consistent, credible anti-inflation policy, as embodied in the administration's program, the more rapidly will real growth and employment increase.

I would like to just cover the very highlights of the remainder of the report. In chapter 2, we analyze the economic rationale for government intervention and discuss the arguments for limiting the Federal role. We explore federalism as the way to achieve greater efficiency and greater individual freedom.

In chapter 3, we discuss the legacies of the past and explain the nature of the inflation process and the costs and benefits of reducing inflation. We demonstrate the fallacies of policies based on the "Phillips Curve" notion of a trade-off between inflation and unemployment.

And the chart that is in my prepared statement was not prepared by Rube Goldberg. That is a statistical rendition, as accurately as we could, of the relationship between inflation and unemployment in recent years.

We also examine monetary policy and have some observations on how the gold standard operated in the past.

In chapter 4, we discuss many of the implications of the fiscal year 1983 budget and also discuss the impacts of the defense bill.

In chapter 5, we review the economic implications of the 1981 Tax Act. Incidentally, we show in passing how overly rapid expansion of the money supply can act as a tax.

In chapter 6, we analyze the progress that's been made in reforming Government regulation and some of the additional progress that needs to be made.

Chapter 7 covers the international area and international effects of the domestic programs.

Finally, in chapter 8, we examine economic conditions in 1981, showing the extent to which they reflected the policies of the past and the necessary corrections to them. We show how current policies and conditions provide the basis for anticipating strong recovery in the second half of 1982.

In this chapter, we review employment developments during 1981. We conclude with a discussion, as required by the Humphrey-Hawkins Act, of important economic trends out to 1987, and that information is contained in table 2.

BUDGET DEFICITS

I would like to turn to the question of budget deficits. To be blunt, the current deficit is higher than I would like it to be. But given the recession, I believe that the sensible approach is to plan carefully for reducing the deficit in the years that follow.

The economic impact of deficits depends on the context in which they occur. The relative size of the deficit is far more important than the dollar magnitude. The effects of a deficit will be relatively small in a large economy and large in a small economy. From an historical perspective, in absolute size the projected deficit for fiscal years 1982 to 1984 surely are substantial, yet they are not unprecedented when we measure them against the size of the economy or of the budget, or of the pool of private saving available to finance them.

As shown, in table 3, in the 1975–76 time period, the relative size of the deficit was larger than we are projecting today. Specifically, the deficit was 4 percent of GNP in fiscal 1976. That compares to our current estimate of 3.2 percent in 1982 and 2.7 in 1983.

Similarly, as a percentage of private saving, the deficit was over 22 percent in fiscal 1976, compared to 19 percent this year and a shade under 15 percent in 1983. As a percentage of the total budget, the deficit was almost 14 percent in fiscal 1975 to over 18 percent in 1976, and we expect it to be under 14 percent this year and about 12 percent in 1982.

I would note that the 1976 deficit occurred during a period of economic recovery. In the year ending June 1976, GNP rose 12 percent, real growth increased 6 percent, and interest rates, although fluctuating, were essentially unchanged.

The condition of the economy, as well as its size, is also relevant for considering the economic effects of deficits. Given the historical experience I have just described, it is important to reduce the deficit financing of the Government in fiscal 1983 from this year's level. Next year is a period in which we expect the private sector, and its financing requirements, to be expanding significantly. During a period of recession, such as now, the borrowing requirements of business and consumers are relatively small. At such a time, a given deficit can be financed with less pressure on interest rates, and therefore, less danger of "crowding out," than when the economy and private demands for credit are strong. But in fiscal 1983 and beyond, when we expect a period of rapid growth in the economy, reductions in the budget deficit, and in off-budget financing will be very much in order, and will be needed to attain the levels of growth and employment that we project.

Financing budget deficits may decrease the amount of private savings and foreign capital inflows that otherwise would be available to the private sector. But I do note that foreign capital has been used frequently in the past for financing portions of the Federal deficit.

MONETARY POLICY AND INTEREST RATES

A lower rate of private investment, of course, would tend to reduce the economy's long-term growth. The Federal Government's demand for funds is insensitive to changes in interest rates; thus, weak and marginal borrowers may be "rationed" out of the market by higher interest rates if savings flows are not adequate, which of course explains our emphasis on tax cuts which provide such strong incentives to saving.

By the way, a higher volume of Federal borrowing to finance deficits makes the Fed's task of monetary restraint more difficult. But, and this is a fundamental difference, for the inflationary potential of deficits to be realized, they must be monetized by the Fed. This administration strongly supports a policy of gradually reducing the growth in the supply of money. I believe that the Federal Reserve System is determined to maintain such a policy.

FINANCING GOVERNMENT SPENDING

The fundamental policy question facing both the administration and Congress is simple, but not easily solved. Government spending can never be costless. That is why the first challenge is to get spending under control. The second challenge is to determine the best combination of ways to finance that spending. All methods of paying the Government's bills, whether it is rasing money by taxes, issuing Government bonds, or expanding the monetary base, impose real costs on the economy. The choice involves which involves the lowest costs, or on which imposes the most appropriate pattern of costs over time.

The 1983 budget reflects the administration's answer to this difficult question of how best to finance Federal spending. We have made it clear to the Federal Reserve that we are not interested in financing Government spending by excessive growth in monty. Thus, in addition to our targeted spending cuts, our budget includes proposals that will result in added revenues of $34 billion over the next 3 years. The remainder of the spending gap will have to be financed with Government securities acquired by a wide variety of domestic and financial institutions and individuals.

We believe that this administration's plan, with its combination of spending cuts, revenue-raising measures, and the declining patterns of borrowing, minimizes the cost to the economy in terms of long-run economic growth, employment, and inflation. In other words, given the economic realities that we face, the President's 1983 budget represents the proper balance of spending, taxing, and borrowing during a difficult period of transition.

Thank you very much.

[The prepared statement of Mr. Weidenbaum follows:]

PREPARED STATEMENT OF HON. MURRAY L. WEIDENBAUM

Mr. Chairman and Members of the Committee:

I am pleased to appear before you this morning to discuss the 1982 Economic Report of the President and the Report of the Council of Economic Advisers. I am accompanied by my fellow Council members, Dr. Jerry Jordan and Dr. William Niskanen.

While there are many important and interesting issues covered in these two documents, I would like to summarize some of the critical issues that we raise.

The Role of the Federal Government

Throughout the President's Report one fundamental theme is clear: the need to redefine the role of the Federal government in our economy. As the President has made clear on numerous occasions, his economic program is designed to deal with the long-run problems which have been afflicting the U.S.economy for a decade and more - high inflation, low saving and investment, stagnant productivity,and insufficient jobs. Many of these problems, in our view, are connected with poor government policies of the past, policies which sought to involve the Federal government at both the macro level ("fine-tuning") and at the micro level (as exemplified by the extraordinary growth in Federal regulation).

This Administration has taken a fundamentally different approach to economic policy. As the President's Report states, "Economic policy must seek to create a climate that encourages the development of private institutions conducive to individual responsibility and initiative." While there is a range of appropriate activities for the Federal government, we believe that if we are to have a healthy, growing economy, the Federal government's role will have to be considerably changed from the past.

Six Key Points

Let me now summarize some of the key statements made in the Council's Report to the President, as they appear in Chapter 1.

Output and employment in 1982 are expected to increase at a moderate rate in the second quarter and at a brisk pace through the rest of the year, probably in excess of a 5 percent annual rate. Inflation is likely to continue to decline and to average about 7 percent for the year, with further progress in 1983 and beyond (see Table 1).

Table 1--Economic Outlook for 1982

Item	1981 1/	Forecast range 1982
Growth, fourth quarter to fourth quarter (percent):		
Real gross national product........	0.7	3.0
Personal consumption expenditures....................	1.2	2-1/2 to 3-1/2
Nonresidential fixed investment..	1.4	6-1/2 to 7-1/2
Residential investment...........	-21.9	24 to 27
Federal purchases................	6.6	-2 to -1
State and local purchases........	-2.0	-1-1/2 to -1/2
GNP implicit price deflator........	8.6	7 to 7-1/2
Compensation per hour 2/...........	9.3	8 to 9
Output per hour 2/.................	-.5	1 to 1-1/2

1/ Preliminary.
2/ Private business, all employees.

Sources: Department of Commerce (Bureau of Economic Analysis), Department of Labor (Bureau of Labor Statistics), and Council of Economic Advisers.

We believe that the condition and policies currently in place -- recent and prospective tax cuts, a lower rate of inflation, and a continuing advance in defense industry activity -- provide the basis for a strong second half in the economy.

2. Prospective budget deficits reflect the effects of the recession, lower inflation, tax law changes and the need to rebuild our defenses. Although the prospective deficits are undesirably high, they are not expected to jeopardize a revival in business investment, and will show a declining trend.

3. Concerns that the Federal Reserve's targets for money growth are not compatible with the vigorous upturn in economic activity envisioned later in 1982 are unjustified. Fears that the upturn will lead to a sharp upswing in interest rates and choke off recovery, while understandable on the basis of previous history and policies, are unjustified in light of current policies and the Administration's determination to carry them through.

4. The economy in 1981 reflected the policies of the past and the transitory effects of the necessary changes in those policies. Since the Administration's economic policies are designed to increase long-term economic growth and to reduce inflation, they were not expected to have immediate favorable effects.

The primary policy element that affected economic conditions in 1981 was the reduction in the growth of the money supply relative to the record high rate of late 1980. That monetary restraint reduced inflation and short-term interest rates, but also influenced the general contour of economic activity in late 1981.

5. The speed with which the economy adjusts to the Administration's policies is closely connected with the extent to which individuals believe the Administration will maintain, unchanged, its basic approach to personal and business taxation, Federal spending and regulation, and monetary policy. When public expectations fully adjust to this commitment, a necessary condition for both reduced inflation and higher growth will be fully established. In other words, what some people have referred to as "monetarism" and "supply-side economics" are two sides of the same coin -- compatible and necessary measures to both reduce inflation and increase economic growth.

This emphasis on expectations has particular relevance for the trend in interest rates during 1982 and beyond. Interest rates, after more than a decade of rising inflationary pressures, still contain sizable premiums to compensate lenders for the anticipated loss in value of future repayments of principal. Those premiums will continue to decline throughout 1982 and beyond, even while "real" (inflation-adjusted) interest rates remain high as a result of private and public sector credit demands. Thus, market rates of interest are likely to continue trending downward, even though short-run fluctuations in the trend can be expected. A critical assumption is that inflationary expectations will, in fact, continue to recede. If they fall at a relatively fast rate, market rates of interest will decline significantly, wage demands will continue to moderate, and the pro-inflationary biases that have developed throughout the economy over the past decade will quickly disappear.

6. Thus, the greater the degree of cooperation between the Administration, the Congress, and the Federal Reserve in continuing to support a consistent, credible anti-inflation policy, as embodied in the Administration's program, the more rapidly will real growth and employment increase.

Chapter Summary of the Report

Let me now present the highlights of the remainder of the Council of Economic Advisers' Annual Report.

Chapter 2 - Government and the Economy

After discussing the links between political freedom and economic freedom, we analyze the economic rationale for government intervention and discuss the arguments for limiting the Federal role in the economy. We explore Federalism as a way to achieve both greater efficiency in the provision of public services and greater individual freedom and choice.

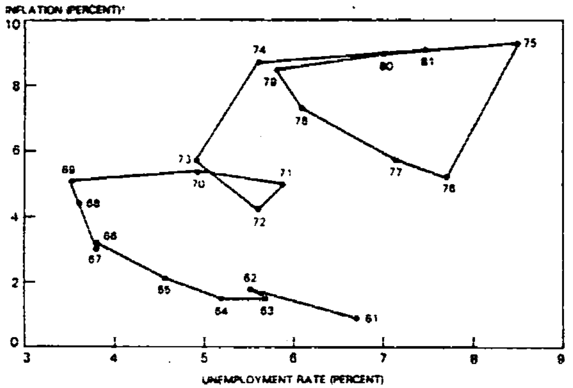
We conclude Chapter 2 with a discussion of the principles guiding the President's program: emphasis on personal responsibility, reform of regulation, strengthened federalism, the need for a long-run focus, and increased reliance on the market.

Chapter 3 - Monetary Policy, Inflation and Employment

We begin Chapter 3 with a discussion of the "legacies of the past" (the belief in fine-tuning the economy, stagflation, and the trend of rising inflation). We explain the nature of the inflation process and the costs and benefits of reducing inflation with particular attention to how those adjustment costs can be reduced by making policy consistent and credible. We demonstrate the fallacies of policies based on the "Phillips Curve" notion of a tradeoff between inflation and unemployment (see Figure 1).

Chart 3-1

Inflation and Unemployment Rate



[1] PERCENT CHANGE IN GNP IMPLICIT PRICE DEFLATOR

SOURCES: DEPARTMENT OF COMMERCE AND DEPARTMENT OF LABOR.

We also examine monetary policy and review Federal Reserve operating procedures. In a short discussion of the gold standard, we show how price and output levels were unstable during the 19th century. We conclude with a discussion of the nature of a monetary rule and the importance to the world economy of the United States bringing inflation fully under control.

We discuss the implications of the defense build-up for the economy. We also explain how a reorientation of the Federal budget can help strengthen State governments and the Federal system. We conclude with a discussion of why Federal deficits matter, a subject that I will discuss in more detail in a moment.

Chapter 5 - Tax Policy and Economic Growth

In this chapter we review many of the economic implications of the Economic Recovery Tax Act of 1981. We begin with a discussion of recent trends in economic growth and the economy's future potential, and review our knowledge of the causes of declining productivity growth. Our discussion of the economic effects of tax policy includes an examination of changes in effective personal and business tax rates through 1986. We also show how overly rapid expansion of the money supply can act as a tax.

Chapter 6 - Reforming Government Regulation of Economic Activity

In this chapter we examine the growth of Federal regulation and the Administration's program for regulatory relief. We analyze pollution control and health care as examples of how market-oriented approaches can be preferable to detailed regulation. We then review regulatory questions in selected areas, including financial institutions, agriculture and telecommunications.

Chapter 7 - The United States in the International Economy

In this chapter we cover three areas important to U. S. international economic policy: the role of the dollar in the international monetary system, the increased importance of international trade and finance for the U. S. economy, and the evolving role of international institutions in promoting a more open economic environment.

Our analysis emphasizes how sound economic policies at home can lead to an expanded role for the dollar in world trade and finance and a more stable international monetary system. We also explain the basis for our policy of non-intervention in foreign exchange markets.

Chapter 8 - Review and Outlook

In our final chapter, we cover economic developments in 1981 and the extent to which they reflected the policies of the past and the necessary corrections to them. We show how current policies and conditions provide the basis for anticipating strong recovery in the second half of 1982.

In this chapter, we review employment developments during 1981. We conclude with a discussion, as required by law, of important economic trends out to 1987. Table 2 summarizes this information.

Table 2--Economic Projections, 1982-1987

Item	1982	1983	1984	1985	1986	1987
	Level					
Employment (millions) 1/	100.9	103.8	106.2	108.6	110.9	113.0
Unemployment rate (percent)	8.9	7.9	7.1	6.4	5.8	5.3
Federal outlays as percent of GNP (fiscal year basis)	23.5	22.1	21.3	21.0	20.4	19.7
	Percent change, fourth quarter to fourth quarter					
Consumer prices	6.6	5.1	4.7	4.6	4.6	4.4
Real GNP	3.0	5.2	4.9	4.6	4.3	4.3
Real disposable income	4.3	4.1	2.7	4.6	4.0	4.0
Productivity 2/	.6	2.3	2.7	2.6	2.6	2.6

1/ Includes 1980 census benchmark.
2/ Real GNP per hour worked.
Source: Council of Economic Advisers

Financing Those Deficits

I now would like to turn to the question of the budget deficits and how they will be financed. To be blunt, the current deficit is higher than I would like it to be but, given the recession, I believe the sensible approach is to plan carefully for reducing the deficit in the years that follow.

The economic impact of deficits depends on the context in which they occur. The relative size of the deficits is far more important than the dollar magnitude. The effects of a given deficit will be relatively small in a large economy and large in a small economy. From an historical perspective, in absolute size the projected budget deficits for fiscal years 1982-1984 are substantial. Yet they are not unprecedented when measured against the size of the economy, or of the budget, or of the pool of private saving that will be available to finance these deficits.

As shown, in Table 3, in the 1975-76 time period, the relative size of the Federal deficit was larger than we are projecting. Specifically, the deficit was 4.0 percent of GNP in fiscal 1976 compared to our current estimate of 3.2 percent in fiscal 1982 and 2.7 percent for the budget now under review, fiscal 1983. Similarly, as a percentage of private saving, the deficit represented 22.5 percent of total private saving in fiscal 1976, compared to 19.1 percent this year and 14.9 percent in 1983. Also, the deficit as a percent of total budget outlays was 13.9 percent in fiscal 1975 and 18.2 percent in FY 1976. This is in contrast to the anticipated 13.6 percent in FY 1982 and 12.1 percent in FY 1983.

Table 3

The Deficit in Perspective

Fiscal Year	Budget Deficit: Billions of $	Percent of GNP	Percent of Private Saving	Percent of Budget Outlays
1972	-23.4	2.1	12.8	10.1
1973	-14.8	1.2	7.2	6.0
1974	-4.7	.3	2.0	1.8
1975	-45.7	3.1	17.8	13.9
1976	-66.4	4.0	22.5	18.2
1977	-44.9	2.4	14.5	11.2
1978	-48.8	2.3	14.1	10.9
1979	-27.7	1.2	7.1	5.6
1980	-59.6	2.3	14.1	10.3
1981	-57.9	2.0	12.5	8.8
1982 estimate	-98.6	3.2	19.1	13.6
1983 estimate	-91.5	2.7	14.9	12.1
1984 estimate	-82.9	2.2	11.6	10.3
1985 estimate	-71.9	1.7	n.a.	n.a

It is worth noting that the 1976 deficit occurred during a period of economic recovery. In the year ending June 1976, GNP rose 12 percent, real growth increased 6 percent and interest rates, although fluctuating occasionally, were essentially unchanged.

The condition of the economy, as well as its size, is also relevant for considering the economic effects of deficits. Given the historical experience I have just described it is therefore important, in my judgment, to reduce the deficit financing of the Federal Government in fiscal year 1983 from this year's level. Next year is a period in which we expect the private sector -- and its financing requirements -- to be expanding significantly. During a time of recession, such as the present, the borrowing requirements of business and consumers tend to be relatively small. At such a time, a given deficit can be financed with less pressure on interest rates, and therefore less danger of "crowding out", than when the economy and private demands for credit are strong. But in fiscal 1983 and beyond, when we expect a period of rapid growth in the economy, reductions in the budget deficit -- and in off-budget financing -- will be very much in order.

Financing budget deficits may decrease the amount of private saving and foreign capital inflows that otherwise would be available to the private sector. A lower rate of private investment, in turn, would tend to reduce the economy's long-term growth prospects. The Federal Government's demand for funds is insensitive to changes in interest rates; thus weak and marginal borrowers may be "rationed" out of the market by higher interest rates if saving flows are not adequate.

A higher volume of Federal borrowing to finance deficits makes the Federal Reserve's task of monetary restraint more difficult. But for the inflationary potential of deficits to be realized, they must be monetized by the Federal Reserve. The Administration strongly supports a policy of gradually reducing the growth in the supply of money. I believe that the Federal Reserve System is determined to maintain such a policy.

The fundamental policy question facing both the Administration and Congress is simple, but not easily solved. Government spending can never be costless. That is why the first challenge is to get spending under control. The second challenge is to determine the best combination of ways to finance that spending. All methods of paying the government's bills -- whether it is raising money by taxes, issuing government bonds, or expanding the monetary base impose real costs on the economy. The choice among financing mechanisms depends on which involves the lowest costs, or on which imposes the most appropriate pattern of costs over time.

The 1983 Budget reflects the Administration's answer to this difficult question of how best to finance Federal spending. We have made it clear to the Federal Reserve that we are not interested in financing government spending by excessive growth in money. Thus, in addition to our targetted spending cuts our budget includes proposals that will result in added revenues of $34 billion over the next three years. The remainder of the spending gap will have to be financed with government securities that will be acquired by a wide variety of domestic and foreign institutions and individuals.

We believe that our plan, with its combination of spending cuts, revenue raising measures, and declining patterns of borrowing, minimizes the costs to the economy in terms of long-run economic growth, employment, and inflation. In other words, given the economic realities that we face, the President's 1983 budget represents the proper balance of spending, taxing and borrowing during a difficult period of transition.

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TIMING OF REAGAN POLICY MEASURES

Representative REUSS. Thank you, Mr. Weidenbaum. We shall now inquire under the 10-minute rule.

On page 36 of the report, I note your criticism of fine-tuning, and that is repeated in your prepared statement today, where you say on the first page that fine-tuning policies are connected with poor government policies of the past. Considerable real tax increase on the great body of Americans right now—the January increase in the payroll social security tax paid by everybody who works, and the inflationary bracket creep which continues for moderate income people, all of this tax increase at a time of severe unemployment and recession. And then when you project a booming economy and the dangers of renewed inflation; namely, in July 1983, you're fine-tuning in an inflationary tax decrease of 10 percent, without coming to any final judgment as to the wisdom or unwisdom of fine-tuning. Isn't this kind of perverse fine-turning about as poor a policy as can be devised? In other words, intensify the recession by your fine-tuning and heat up the inflation.

Mr. WEIDENBAUM. Of course not. First of all, I think the chairman is excessively generous in allocating the credit for the increase in the social security tax.

Representative REUSS. We tried to get President Reagan to change and alter that. He refused.

Mr. WEIDENBAUM. I believe that tax was enacted as a necessary financing of the social security system. But my knowledge of American history tells me that it was the Congress that enacted those benefits, it was the Congress that passed those taxes. I think it's perfectly in order. But for you to try to give the President sole credit for the taxes that you levied and you to take the sole credit for the benefits paid out in those taxes, is a bit ingenuous, I would suggest.

But, in any event, I can't characterize a long-term tax program as fine tuning. If anything, the notion of passing a tax program for the 1980's avoids the stop-and-go policies of the past. It reduces the uncertainty that bedevils financial markets. On the contrary, the 10-percent tax cut scheduled for July 1 is not fine tuning, but part of a long-term program to reduce the share of the national income going to the Federal Government. And the result will be, quite clearly by any standard, a tax reduction for every taxpayer at every income level. In fact, it is a 10-percent across-the-board tax cut for every personal taxpayer in this Nation.

ECONOMIC STRUCTURE AND POLITICAL FREEDOM

Representative REUSS. In your second chapter, you turn to the pleasures of philosophy. On page 27, you say:

> No nation in which the government has the dominant economic role, as measured by the proportion of gross national product originating in the government sector, has maintained broad political freedom.

Well, I have the impression that a number of countries in which the government plays a dominant economic role—Austria, France, Tory Great Britain, for example—that they aren't slave states.

They still have broad political freedom. Can you get one of your in-house historians to give me a rundown on that?

Mr. WEIDENBAUM. Oh, by all means. We had in mind, of course, all of these Soviet bloc nations, where the government sector dominates the GNP.

Representative REUSS. You were talking, then, just about the Reds, eh? [Laughter.]

Mr. WEIDENBAUM. I wouldn't exclude them from the analysis.

Representative REUSS. You got any Pinks that you'd like to include in your list?

Mr. WEIDENBAUM. Excuse me?

Representative REUSS. Any non-Soviet bloc countries that you wish to stigmatize?

Mr. WEIDENBAUM. Not particularly, but I would like to call upon my distinguished colleague, Mr. Niskanen——

Representative REUSS. And Mr. Jordan. Let's see if we can make a little list.

Mr. WEIDENBAUM [continuing]. To see if he has any observations on this subject.

Mr. NISKANEN. The important observation is that a private market appears to be a necessary, but not a sufficient criterion, for political freedom. The particular statement here is based upon the proportion of the gross output for a country that originates in the government sector. That is a smaller proportion in most countries than the relative size of the government budgets because a great deal of the government budgets are in the form of transfer payments.

This statement is accurate with respect to that particular statistic. It is also important to recognize that a private market is not a sufficient guarantee of political freedom. It does appear to be a necessary guarantee.

TRUCKING DEREGULATION

Representative REUSS. Well, to turn to something, and there are some things where I find myself in agreement with you, I commend you in general for the blow you strike for competition. It's a good thing.

Mr. WEIDENBAUM. Thank you, Mr. Chairman.

Representative REUSS. I'm for it.

Mr. WEIDENBAUM. We appreciate your support.

Representative REUSS. On page 162, for example, you very largely track the bipartisan recommendations made by this committee recently when we were very disturbed by the backsliding by the Interstate Commerce Commission on trucking deregulation. For a while, it looked as if they'd come to their senses and were going to introduce competition. But since then, they've gone back to cartelizing it.

You say on page 162 sort of the same thing:

> More recently, however, the pace of regulatory reform has slowed. Restrictions on the scope of new certificates have increased and some applications for rate reductions have been rejected by the ICC. Discounts offered to shippers have been called blatantly illegal.

Good for you. I think your vision is excellent. As advisers to the President, have you shown him this and urged him to call the present leadership of the Interstate Commerce Commission before him and tell them to drop their cartelization penchant and work, instead, for competition?

Mr. WEIDENBAUM. We are mindful, of course, that the Interstate Commerce Commission, as determined by the Congress, is an independent regulatory agency.

Representative REUSS. All I ask is the same kind of thing which the President did with that other independent regulatory agent, Paul Volcker, yesterday. Have a little stimulating chat with Chairman Reese Taylor.

Mr. WEIDENBAUM. I've had a stimulating chat with Chairman Reese Taylor.

Representative REUSS. I think very highly of you, but evidently Reese Taylor doesn't because he's keeping on doing what he's been doing. But the President appointed him. Wouldn't it be a good idea if the President called Mr. Taylor in and told him to fly straight?

Mr. WEIDENBAUM. I'll be pleased to relay that recommendation to the President.

Representative REUSS. I thank you very much. Take another——

Mr. WEIDENBAUM. I was not aware that the President and Mr. Volcker had a meeting yesterday—Monday.

ANTITRUST LAWS AND THE BEER INDUSTRY

Representative REUSS. Monday. I stand corrected. On page 32, you turn your attention to the antitrust laws, and there you say, with some pride:

> This Administration has already made some changes in policy in the administration of federal anti-trust laws, changes based on economic analysis. First, a merger between two firms which have a relatively small share of the market should be allowed, for there is little danger of monopoly.

I agree. Good sense. Good for you. However, how do you account for the fact that the Department of Justice, just a few months ago, threatened to sue Heileman and Schlitz, which controls 6 to 8 percent, respectively, of America's brewing industry? They wanted to combine so they could run with the giants, Anheuser Busch and Miller, who, between them, control the lion's share of the industry. I'm not sure that you were aware of what the Department of Justice did. But now that you are made aware of it, could I ask you to make it your business at your earliest opportunity to ask the President, as his economic adviser, to call in the Department of Justice and tell them to reverse themselves, withdraw their opposition, and pat these two little competitors on the back for wanting to get together and give the biggies some competition.

Mr. WEIDENBAUM. I appreciate the suggestion, Mr. Chairman, but frankly, I do not intend to do that. The distinguished Milwaukee company that you mentioned——

Representative REUSS. Which one? Miller, the big one or Schlitz, the little one?

Mr. WEIDENBAUM. I'll let you——

Representative REUSS. We've got them all. [Laughter.]

Mr. WEIDENBAUM. Will have to enjoy the opportunities of competition as they remain in that competitive market.

Representative REUSS. But then, why did you say that a merger between two firms which have a relatively small share of the market should be allowed? Do you withdraw that statement?

Mr. WEIDENBAUM. No, I do not. That is the position that the Council took.

Representative REUSS. Well, you can't have it both ways. Either advise the President to advise the Department of Justice that they're going wrong, or withdraw the statement.

Mr. WEIDENBAUM. Mr. Chairman, I stand behind the statement. I think it's a fine statement.

Mr. NISKANEN. Chairman Reuss, I think our most direct answer is that we do not understand the position of the Justice Department on this particular case.

Representative REUSS. You don't understand it or I don't?

Mr. NISKANEN. We do not.

Representative REUSS. Well, let me tell you, it's very simple. They sent a one-line letter to Heileman and Schlitz saying, if you merge, we'll sue you under the antitrust laws.

Mr. NISKANEN. We understand what the outcome was. We do not understand the basis of the outcome.

Representative REUSS. Well, would you, as advisers to the President, make it your business to try to understand it? And if you agree with my analysis, and with the statement you made, advise him that he should tell the Department of Justice to review the matter? Fair enough?

Mr. WEIDENBAUM. Very frankly, the subjects that it is appropriate for the Council of Economic Advisers to advise the President on cover a wide terrain. But the management of specific departments is the ultimate responsibility of the Cabinet officer reporting to the President.

Representative REUSS. A moment ago, I cheered you when you said you'd be willing to ask the President to tell an independent agency, the Interstate Commerce Commission, to stop cartelizing. I don't see why you can't tell them to tell his appointee, a nonindependent agency, to stop cartelizing.

Mr. WEIDENBAUM. If you press me, as you are, Mr. Chairman, I must respond then.

Representative REUSS. I didn't mean to press you.

Mr. WEIDENBAUM. The President's time being limited, I thought that there ought to be some judgment on my part as to how many different matters I broach at any time.

Representative REUSS. Surely. Congressman Mitchell.

Representative MITCHELL. Thank you. Mr. Niskanen, I understand and I'm sympathetic with your position when you say you did not understand what the Justice Department's position is—not to be sympathetic—because we have a similar occurrence in which the Treasury Department made an extremely venal move with regard to racist schools and the administration didn't understand that.

So, Mr. Chairman, I don't think that you ought to press too hard on that. There are many things that the administration does not understand.

SHORT TERM EFFECTS OF REAGAN PROGRAM

Mr. Weidenbaum, I just want to comment briefly on your statement about the change with reference to providing programs in jobs for people that did not solve the minority and employment problem and need help. I would like to say that the policies that have been instituted by this administration have exacerbated the problem. They haven't reduced it any; it's gotten worse, not better.

Now I think every economist, no matter what his or her persuasion might be, is in agreement that if your program goes through, it's going to take some time. There's no doubt about that.

The problem is what happens to the lives of people in the interim. Suppose it takes 2 years before we see any salutary results. Is the administration so bereft of compassion and caring? Is it prepared to treat people as expendable items, waiting for these salutary developments to take place?

Mr. Weidenbaum, that's my only concern, really—that the administration does appear to be absolutely callous toward people in the interim. I hope your program will work. I hope that it will. Maybe it will work. I don't think so, but I hope it will.

But in the meanwhile, we've got to do something to prevent people from being almost psychologically destroyed.

Let me put one question to you and then you respond as you will. I have two questions to lead off. Inflation is down. No question about it. Yet, I went to one of the national publications which said, the number one problem for America right now is unemployment.

Have we increased unemployment to bring down inflation? It seems fairly obvious to me that if people are out of work, they're not going to be purchasing very much. And if they're not going to purchase much, then the rate or the price of goods and services will decrease.

Is this really not a sort of quid pro quo tradeoff, where we agree, or you have agreed, to let unemployment reach a certain point and then properly claim credit for reducing inflation?

Mr. WEIDENBAUM. Congressman Mitchell, I'd first of all like to point out that, contrary to what may be an impression, this administration is spending rising amounts, rising shares of the Federal budget to provide income support to those who are dependent upon the Government, to the needy. For example, on page 3–34 of the 1983 budget, there is an interesting table of budget outlays by functions. Take the income security category. That is the category that includes social security, unemployment compensation, and food and nutrition assistance and you see steadily rising outlays for every year in the future.

Representative MITCHELL. Well, that's being done only because you're creating additional numbers of people needing the salaries. The President came in and asked for $2.1 billion for unemployment benefits, and I voted for it. But the reason for that is—that's almost a forced expenditure.

Mr. WEIDENBAUM. But if you're concerned about the compassion of this administration, let me assure you that devoting a rising share of the budget during a period of budget restraint to these programs is our true measure of compassion.

Representative MITCHELL. If you take it from that position to vote for an increase, it may well be that the administration is compassionate. On the other hand, to create the conditions which cause people to need this, is a noncompassionate myth.

Mr. WEIDENBAUM. May I respond, please?

Representative MITCHELL. Sure.

Mr. WEIDENBAUM. If you're concerned with who caused the conditions, it's quite clear to me that the excesses of the past—that is, the policies that generated the economic environment that we inherited—are the fundamental cause.

Representative MITCHELL. That's the overall traditional response of every spokesperson——

Mr. WEIDENBAUM. It's true, believe me.

Representative MITCHELL. If I may, please—of every spokesperson for the administration. Now I will be the first to admit that there have been some things that have been done wrong in the past. But I think it's totally and terribly wrong to suggest that this is the sole reason for the serious economic condition that grips this Nation right now.

Now I only have a little bit of time. Could I shift to one other point that I wanted to ask you?

Mr. WEIDENBAUM. Am I going to have a chance to respond, because it's quite clear to me that if in the second half of 1980 we hadn't witnessed the fastest rise in money growth in modern times, we wouldn't have inherited an escalating double-digit inflation. We wouldn't have been faced with dealing with that situation.

Representative MITCHELL. Then you just corrected yourself because you were suggesting that it was simply the Government's spending, but it's not just that. It's the policies of the Federal Reserve. That's the point I was trying to make and you've aided me in making that point clear.

Mr. WEIDENBAUM. Fine.

IMPACT OF MILITARY SPENDING ON THE ECONOMY

Representative MITCHELL. With \$1.5 trillion to be spent on the military over the next 4 or 5 years, who should tell me what is the productive capacity of the military industrial complex right now? Are the factories operating at 70 percent, 80 percent, 90 percent?

Mr. WEIDENBAUM. As a long-term student of that subject, I have to report that there isn't a single comprehensive measure. But if you look at the major defense-supplying industries, like the aerospace, they have more excess capacity than manufacturing in general.

Representative MITCHELL. My point is that, having served on this committee and on the now-defunct Joint Committee on Defense Production, time and time again we've seen the appalling statistics about the amount of money that has already been appropriated to the military over the years, the appalling amount that we simply have not spent.

I don't recall what the last figure is, but I think it was something like \$11 billion, or much more than that. Maybe 10 times that much.

Mr. WEIDENBAUM. Oh, it's much more than that.

Representative MITCHELL. Yes, $100 billion, maybe, in unobligated money and nonexpended money. Now why do we keep throwing good money after bad? The assumption is, of course, that much of this goes into R. & D., research and development, and it takes 5 years to come up with something.

Mr. WEIDENBAUM. Yes, sir.

Representative MITCHELL. The counter, the response to that argument is that by the time we come up with something new, the new tank, the new aircraft, the new nuclear weapon or something, by that time it's already obsolete, as has been reported in the case of some of the tanks that are being manufactured right now.

I would simply say that I think that it's a very foolish position to take to just throw money into the military without any careful planning as to how that money can be spent wisely.

Let me just give you one illustration and then I'll let you respond.

A gentleman got a contract from the military. I forget what it was for. He had been striving for a couple of years to get that contract. He came in to me just gleeful that he had gotten this contract. And he said, the colonel who had signed off on it said, Oh, let him have it. We've got to get rid of the money, anyway.

This shoving money into the military creates, really, an attitude to waste. Mr. Weidenbaum, do you care to respond?

Mr. WEIDENBAUM. I'll let Secretary Weinberger respond on the details of the military budget. But it's quite clear to me that, given the shortcoming of military funding in the past, there's a lot of catchup that needs to be done. And the sooner we restore the needed strength of our military establishment, not only the sooner will we strengthen our national security, the lower that bill will be.

But in our report, we urge multiyear procurement as a more economic device. And yes, that does mean that Congress appropriates early in the cycle the large sums needed to produce a weapons system during its production life. And the result is those large, unexpended balances that you've described. I think that that makes for a far more effective production program than we saw too frequently in the past—annual increments which resulted in uneconomical production rates.

Representative MITCHELL. I understand that I have 1 minute left. My position is that you can't unbuild standards. If you're going to take that position with the military, then you ought also to take that position with some of the social programs, which we never guarantee that they will miraculously solve problems in 5 years or 10 years—the long haul that the administration always talked about.

So I am just perplexed. I am perplexed.

Mr. WEIDENBAUM. I don't know why because if you look at the permanent appropriations, the indefinite appropriations—I'm using technical budget terminology now, you recognize—virtually all of the so-called uncontrollable outlays in the Federal Government are in the social, in the welfare area. It's the Department of Defense that has to go to the Congress each year for appropriations, for everything except retired pay. It's so many of the social programs that are insulated.

Representative MITCHELL. You're telling me that those social programs are not on the President's hitlist? Yes, they are. Thank you. My time is expired.

Mr. WEIDENBAUM. I'm not familiar with any hitlist. I'd be glad to review any if you had any.

Representative REUSS. Thank you. The gentleman from California, flanked by two other great Californians this morning.

Representative ROUSSELOT. Thank you, Mr. Chairman, and I didn't know that we were going to have pictures today. Is this show-and-tell day? [Laughter.]

We just celebrated his birthday and I remember how many great programs he brought to this country, including the incarceration of the Japanese just a few blocks from my home, against the Constitution. I remember that, specifically.

I appreciate your bringing the pictures. Are we to bring pictures?

Representative REUSS. Optional.

Representative ROUSSELOT. Oh, optional. [Laughter.]

Mr. Weidenbaum, I appreciate the chance to review your testimony. My chairman has been gracious enough, I understand, to read the statement that I had. So I guess my thoughts have already been partially expressed.

PROPOSAL TO RESCIND THE JULY 1983 TAX CUT

There's been a great deal of discussion, as you know, by some of my colleagues here to change the tax bill to raise more revenue, I think is their purpose, in the third year. That is, to somehow vote this year to rescind the 10-percent reduction that, for the personal income tax, will go into place in July of 1983. Now we all know that the Democratic proposal in the House included a 5-percent reduction for October 1, a 10-percent reduction for July 1, of this year, so I assume that they're not going to go back on that now. But I'll leave that to my colleagues to handle.

What is your comment about the impact that that might have on savings and investment and et cetera, if we were to do that this year. In other words, make the decision to change taxes for 1983, if somehow we got that through in 1982?

Mr. WEIDENBAUM. Very frankly—and I'll ask Mr. Jordan if he cares to add to the response—I've been concerned, and I've expressed my concern consistently, about a perception of the return to a stop-and-go policy. This came up in our earlier discussion this morning.

Representative ROUSSELOT. Yes.

Mr. WEIDENBAUM. I'm a strong adherent—I have been for many years—to multiyear tax cuts so that consumers and business alike could plan to crank into their planning the future tax system that they'll be operating under. That's why I think it's important to maintain the schedule in the 1981 Tax Act and I do worry that changing the schedule might have an adverse effect on the private sectors decisionmaking and not have, therefore, the consequences on savings or investment that you might otherwise anticipate.

Representative ROUSSELOT. You already have the tax increases that will be in place for social security. I suppose you commented on that, too.

Mr. WEIDENBAUM. Yes. The chairman tried to give the President credit for that and I——

Representative ROUSSELOT. That was voted by a Democratic Congress. I remember that very well. That was in 1977. We all remember that.

Mr. WEIDENBAUM. Yes, indeed.

Representative ROUSSELOT. To increase social security taxes. Of course. I suppose it was to save the system. It's in deep trouble, as we all know.

Will that have an affect, too? I mean, will the personal income tax reduction proposed for 1983, be offset by the Democratic social security increase that was passed in 1977?

Mr. WEIDENBAUM. The total, the net effect is to reduce the tax burden on the average citizen.

For 1983 as a whole, the tax burden of the average citizen will be lower than it is in 1982. And that, of course, is a very basic goal of this administration. Mr. Jordan.

Mr. JORDAN. I think that the multiyear concept followed by indexation is one of the great achievements of this Congress.

TAX CUT EFFECT ON MARGINAL TAX RATES

Representative ROUSSELOT. Well, you know, there have been a lot of voices raised that it was a terrible thing to reduce the taxes because of the great problem with the deficit.

Mr. JORDAN. We think that this tax legislation will have a very stimulative benefit to real growth, to savings, to investment, which I think everyone agrees needs to be done. But we've also pointed out in chapter 5 in the report, that for the same real income levels, even with the multiyear tax reduction, in 1984, individuals with the same real income levels will be paying about the same marginal tax rate. Any decision to delay, postpone, or cancal that third year of the tax cut would be a real increase in taxation. It would be an increase in the real tax burden on the American people, and I think that it would have an adverse effect upon growth, employment, and on investment.

Mr. NISKANEN. Congressman Rousselot, let me follow up on that. It's important to recognize that the personal tax cuts in the 1981 law are barely sufficient to maintain constant marginal rates on real income, given what else is going on. In the absence of those personal tax cuts, marginal rates on people with a family income of $20,000 in 1979 would have gone up from 30 percent to 39 percent, exclusive of the social security tax.

Representative ROUSSELOT. You mean that that would have happened in 1982.

Mr. NISKANEN. That would have happened in the absence of the tax cut. The personal tax cuts in 1981 across the board are really barely sufficient to maintain constant marginal rates on real income, given what else is going on. I would regard it as a great tragedy if, in the name of fine tuning, again, we decided to defer or to modify the personal changes that we put in place last year.

Representative ROUSSELOT. Well, I think in the Economic Report of the President which was given to us in February, on page 119 there is a table to show that the effect of those personal income tax reductions benefits very substantially the people in the lower brackets.

So, Mr. Chairman, I ask unanimous consent that we put into the record at this point some of the figures that we just referred to in table 5-3 on page 119 of the report because it relates to that comment.

Representative REUSS. Without objection, it is so ordered.

[The table follows:]

TABLE 5-3.—COMPARISON OF MARGINAL PERSONAL INCOME TAX RATES BY REAL INCOME LEVEL UNDER THE ECONOMIC RECOVERY TAX ACT OF 1981 AND OLD LAW, 1979-86 [1]

[Percent]

Real income (1979 dollars)	1979	1980	1981 [2]	1982	1983	1984	1985	1986
Single:								
$10,000								
Old law	21	21	21	24	24	24	24	26
New law			21	22	19	18	18	18
$20,000								
Old law	30	30	34	34	34	34	39	39
New law			34	31	28	26	26	26
$30,000								
Old law	39	39	39	44	44	49	49	49
New law			39	40	36	38	38	34
$50,000								
Old law	49	50	50	50	50	50	50	50
New law			49	50	45	48	48	48
Married, two workers:								
$10,000								
Old law	16	16	18	18	18	18	18	18
New law			18	16	15	14	14	14
$20,000								
Old law	21	24	24	24	28	28	28	28
New law			24	22	19	22	18	18
$30,000								
Old law	28	32	32	32	37	37	37	43
New law			32	29	26	28	28	28
$50,000								
Old law	43	43	43	49	49	49	49	49
New law			42	44	40	38	38	38

[1] Excludes social security taxes and State and local income taxes.
[2] Tax rates for 1981 under new law rounded to nearest whole percent.

Source: Department of the Treasury, Office of Tax Analysis.

Representative REUSS. Earlier, the entire report was placed in the hearing record.[1]

Representative ROUSSELOT. Yes.

Representative REUSS. But the gentleman's reference will be preserved.

Representative ROUSSELOT. I just thought that we ought to focus in on it since it was mentioned.

Representative REUSS. Yes.

SPENDING FREEZE PROPOSAL

Representative ROUSSELOT. Mr. Weidenbaum, you may not want to get into this, but since there's been a lot of focus from Congress

[1] The 1982 Economic Report of the President may be found in the committee files.

on ways to save money, especially from the other body, talking about taking expenditures and freezing them, have you had a chance to look at the impact of that on the economy? I'm so delighted to see so many of my colleagues on the other side now concerned about the deficit. When I used to offer my balanced budget resolution, they never voted for it. But I'm delighted to hear of their concern now.

Mr. WEIDENBAUM. Mr. Rousselot, I think it's fascinating that the folks who invented deficit financing are finally learning the dangers of deficit financing.

Representative ROUSSELOT. Yes, I am, too.

Mr. WEIDENBAUM. I think we should welcome the zeal of the newly converted, no matter how late it has come.

Representative ROUSSELOT. They're born-again balanced budget people. We're delighted to have them onboard.

I was wondering if you could comment, what is your analysis of the impact on the general economy if we were, in fact, to somehow forge or fashion a budget resolution that did somehow freeze, including defense, some of the substantial expenditures of the Federal Government, freeze them either at the 1982 level or slightly above? What was your judgment on the impact of that?

Mr. WEIDENBAUM. Congressman Rousselot, we haven't made a specific analysis of such proposals. I can tell you offhand that such a freeze could produce many inequities—such as programs that have outlived their usefulness, and should be reduced, if not terminated—and those inequities would be maintained.

On the other hand, high priority and new programs would not have the opportunity to be expanded. As you know, we are working on the enterprise zone concept——

Representative ROUSSELOT. Yes.

Mr. WEIDENBAUM [continuing]. As an innovative way of dealing with the problems of the central cities.

Representative ROUSSELOT. By the way, this committee had hearings in Los Angeles and other places on the enterprise zone and we had a lot of good testimony.

Mr. WEIDENBAUM. I'm delighted to hear that. However, a freeze would prevent the establishment of an important innovation such as the enterprise zone concept.

Representative ROUSSELOT. But is it totally off the wall for us to think about the concept, and I'm not talking about the programs that maybe Congress agrees should be phased down. We should go ahead with that process. But maybe taking a look at the idea of freezing some of these expenditures.

Mr. WEIDENBAUM. It strikes me that the basic advantage of that approach is to focus, and this is so badly needed in my judgment, public attention on the difficulties and the problem of controlling what has been too great an increase in Government spending.

Representative ROUSSELOT. Right.

Mr. WEIDENBAUM. I personally welcome the increased attention that I sense on both sides of the aisle now to the important problem of restraint in the fiscal 1983 budget. And I hope that the Congress can join with the administration and work together in achieving the necessary reductions in outlays and in the deficit because, as we point out in our economic report, the health of the economy depends so much on sound Government policy.

Representative ROUSSELOT. My time has expired. Thank you for a very complete statement.

Mr. WEIDENBAUM. Thank you.

Representative REUSS. Congressman Richmond.

REAGAN PROGRAM AND OUTLOOK FOR SECOND HALF

Representative RICHMOND. Thank you. Mr. Weidenbaum, we've had so many dialogs, all apparently getting us nowhere. I'm not going to sit here and belabor you over the fact that this administration obviously has very little sensitivity to the needs of the 40 million poor people in the United States, that the cuts you have made in many of the programs are so totally counterproductive—cuts in job-training programs, women's, infants and children nutrition programs. These cuts are so counterproductive. What you're doing is costing us billions and billions of dollars in crime and health care and all the other things.

I mean, I'm not even going to begin to discuss it with you because there's no point. I know that down deep in your heart, you agree with me.

Mr. WEIDENBAUM. Now, you referred to a dialog——

Representative RICHMOND. Never in my life have I read anything containing as many misstatements as this document. You can't possibly believe these things. You can't possibly believe that production is going to go up by 5 percent this year.

Mr. WEIDENBAUM. This must be a monolog.

Representative RICHMOND. Mr. Weidenbaum, did you read the figures in January? Now you say for the year production is going to go up 5 percent? I tell you that it's not going to go up 5 percent.

Mr. WEIDENBAUM. I did not say that production for the year would go up 5 percent.

Representative RICHMOND. You said that in your opening statement and it's here in the book.

Mr. WEIDENBAUM. I said in the second half of the year.

Representative RICHMOND. Mr. Weidenbaum, let me tell you that the second half is not going to be much better than the first half. You know how I know? I know because, as I told you repeatedly, a company in which I have some stock manufactures products for end users. It is typical of many, many American companies that supply machine tools and other equipment to the Fortune 500 companies. Our backlogs of orders are going down, they're not going up. That means only one thing to me. It means we're in a severe recession.

Mr. WEIDENBAUM. No, no.

Representative RICHMOND. And the recession is going to get more severe.

Mr. WEIDENBAUM. I guess it means that your competitors are doing better than you are.

Representative RICHMOND. No, no, that's not what it means at all. [Laughter.]

We happen to run a very, very efficient, clean, and profitable company. The fact is there is no business. One of the greatest companies in the world has closed down. Do you know that the John Deere Co., the greatest agricultural equipment company in the world, was closed down in the month of January? Do you know that Caterpiller, the greatest off-the-road equipment company in the world, is virtually closed down? Do you know that many of our major corporations in the United States are teetering on the brink of bankruptcy?

Now if your tax plan was so good, if your budget plan was so good, if everything was so great, how come nobody in a policymaking position in these companies is willing to modernize their company? How come industrial investment went down instead of up? How come United States Steel, instead of taking that $6 billion that they happen to have—and which is precisely the amount of money they needed to fix up their own mills—went out and bought Marathon Oil?

Mr. WEIDENBAUM. You missed one. How about almost 100 million people are at work today?

Representative RICHMOND. How about the 10 million people that are not working today, Mr. Weidenbaum? How about all the other people who are not even listed as among the unemployed, who haven't even applied for a job?

Mr. WEIDENBAUM. I do think you should look at the donut and not just the hole. And I think you are just looking at the hole and not the donut, and the donut's much larger.

BUSINESS INVESTMENT

Representative RICHMOND. Well, let me just ask you just a couple of specific questions. With this enormous Federal deficit, forcing us to print money—our prime rate went up again yesterday to 17 percent—and I sit here and tell you that the prime rate is going to go up to 20 percent before you know it. It has to go up because the Federal Government is running at such a gigantic deficit, that it must use up all of the money that's available.

Now, I just want to know one thing from you, just one thing. Why are American manufacturers, who are so cozy with the President—you know, big business and the President are virtually synonymous.

Mr. WEIDENBAUM. That's news to me.

Representative RICHMOND. How come they're not modernizing their factories? How come they're not buying machine tools? How come they're not using this period to really spend money to improve their factories?

You say they're spending money and I can tell you that they're not.

Mr. WEIDENBAUM. Now how much time do I have to correct those misimpressions? I don't want to overstay my welcome.

Representative ROUSSELOT. Equal time. We believe in equal time here.

Representative REUSS. The chairman will respond.

Mr. WEIDENBAUM. I thank the members of the committee and the chairman. Congressman Richmond, you must have been reading a different document. If you read our report, the one that we submitted, I think you will find a very balanced statement. First of all, we know that business investment is traditionally a lagging indicator. It's the last major sector of the economy to turn down. It's running true to form.

Representative RICHMOND. But you say it's going to go up 6½ percent this year. The Commerce Department says that it's going to go down by a half percent. Make up your mind.

Mr. WEIDENBAUM. We are very consistent. If you look at——

Representative RICHMOND. Well, what about the Commerce Department that says it is going to go down by a half of 1 percent?

Mr. WEIDENBAUM. As you point out, at the 5-percent figure——

Representative RICHMOND. But you said 6½ in your study.

Mr. WEIDENBAUM. But earlier, you said real growth, 5 percent per year.

Representative RICHMOND. You said production, 5 percent.

Mr. WEIDENBAUM. We said real growth in production, 0.2 percent increase for the year.

Representative RICHMOND. I'm talking about business investment. Mr. Weidenbaum, you yourself said that business investment was going to go up 6½ percent, your own statement.

Mr. WEIDENBAUM. We have a range.

Representative RICHMOND. All right. The Commerce Department says that it's going to go down by a half percent. Now somebody's got to be wrong.

Mr. WEIDENBAUM. You appreciate the Commerce Department surveys your largest companies, an art which apparently you're enamored with. Our data cover all businesses, large and small. So we do have different numbers of course. And we're talking about the fourth over fourth, the fourth quarter over quarter.

I suggest, Congressman Richmond, that our value judgments may be different, but in terms of information, if you read the report carefully, you will see that it's a fairly balanced appaisal of where we've been, where we are. It doesn't have easy answers.

Representative RICHMOND. That's the opposite of what's actually happening, Mr. Weidenbaum. That's my big problem.

Mr. WEIDENBAUM. Now Congressman Richmond, Congressman Richmond——

Representative RICHMOND. We all refuse to say, we'd better change what we're doing.

Mr. WEIDENBAUM. That's not true. On the contrary——

Representative RICHMOND. You know what I think the smartest thing——

Mr. WEIDENBAUM. I thought I had equal time.

Representative RICHMOND. All right.

WHEN WILL THE RECESSION END?

Mr. WEIDENBAUM. On the contrary, this is not the administration that calls a downturn a growth interruption or a sidewise waffle or a banana. This is the administration whose leader, the President, called the recession a recession, right off the bat. So much for truth in economics.

Representative RICHMOND. Except you say that we're coming out of it. The Secretary of the Treasury was here and he said we're coming out of it in the second quarter. You at least say it's going to be in the second half. I assure you that we're not going to come out of it this year.

Mr. WEIDENBAUM. Now if we say, as we do, that real GNP will rise 0.2 percent in 1982, that is not exactly a boom. And to say that we forecast a boom is a tad exaggerated.

Representative RICHMOND. How can you say that on real GNP and also say that production is going to go up 5 percent, inflation is going to go down to 7 percent, and business investment is going to go up 6½ percent?

Mr. WEIDENBAUM. I suggest, Congressman Richmond, that, and you'll find this very instructive, you look at the recent report of the Congressional Budget Office, what they expect for 1982.

Now, as you know, for real GNP from the fourth quarter of 1981 to the fourth quarter of 1982, we are assuming a 3-percent increase, fourth to fourth. They have a range from 1.8 percent to 3.8 percent. If you look at the following year, again, they have a large and upward range.

We are not alone in projecting a strong economy in the second half. In fact, not only do I have lots of company; the great majority of economic forecasters do anticipate and are telling their clients that the second half of 1982 will be a prosperous period.

Representative RICHMOND. You're wrong, Mr. Weidenbaum, for one reason. They're wrong because running the Federal Government at a $150 billion deficit this year, which it's going to run, is going to——

Mr. WEIDENBAUM. I don't know where you get those numbers.

Representative RICHMOND. Well, I disagree with $100 billion. I feel that it's going to be $150 billion. And I go on record, I guarantee it's going to be $150 billion if we don't do something.

Mr. WEIDENBAUM. I think $99.8 is large enough. I don't think we need $150 billion.

Representative RICHMOND. Mr. Weidenbaum, all I say is it's going to suck up all the money supply. It's going to force interest rates up. It's going to make it impossible for people to borrow money at any reasonable rate, meaning the housing industry is going to stay down, the automotive industry it going to stay down, companies will not invest money in new equipment. I think until we balance the Federal budget——

Mr. WEIDENBAUM. Oh, no, no, no.

Representative RICHMOND [continuing]. We just can't get out of the recession.

Mr. WEIDENBAUM. How you can make a flatout statement, companies won't invest.

Representative RICHMOND. They can't afford to at 20 percent, Mr. Weidenbaum.

Mr. WEIDENBAUM. You just quoted with great approval——

Representative RICHMOND. Commerce said it's going to go down a one-half of 1 percent.

Mr. WEIDENBAUM. That's a lot of investment. Look at how much investment the Commerce Department is forecasting for this year.

Representative RICHMOND. It's not enough, though.

Mr. WEIDENBAUM. And when you say that companies won't invest——

Representative RICHMOND. For us to keep up with Germany, Japan, it's not nearly enough.

Mr. WEIDENBAUM. I'll agree, which is precisely why we've been advocating our program of tax cuts, of regulatory relief, and welcome your support.

Representative RICHMOND. OK, so we gave United States Steel so much regulatory relief and such a nice tax cut, what did they do with it? They went out and they bought Marathon Oil. They didn't use it to fix their own mills. How do you account for that?

Mr. WEIDENBAUM. Now the regulatory relief, I assure you, is not connected with acquisitions. Quite clearly, it enables a steel company to stay in production. And to say the companies can't invest, my goodness, if you look at the tax chapter, chapter 5, of our report, we show what a powerful incentive the new tax law provides to companies to invest.

Representative RICHMOND. But they're not investing. That's my problem with your report.

Mr. WEIDENBAUM. To say that companies are not investing at a time when billions and billions of dollars, tens of billions of dollars of commitments are being made for new investment is patently in error.

Representative RICHMOND. And we both agree that they're not investing nearly enough, Mr. Weidenbaum, in order to keep in competition in the world today. And that's the big serious problem in the United States. And they're never going to invest until they have more confidence in our Government and our budget. Businesses have to run on a balanced budget and I believe that this Government has to run on a balanced budget.

Representative ROUSSELOT. Fine. Offer the amendment.

Mr. WEIDENBAUM. We welcome your support for reducing the deficit and for eliminating deficits. I must say, I learn a lot listening to you, Congressman Richmond. And to hear your support of a balanced budget, welcome aboard.

Representative ROUSSELOT. Terrific. He's going to offer it this year.

Representative RICHMOND. And I wouldn't do it on the backs of the poor people, either, Mr. Weidenbaum.

Mr. WEIDENBAUM. Agreed.

Representative RICHMOND. That's counterproductive. In addition to being cruel, it's also not good business.

Mr. WEIDENBAUM. Agreed, which is why I urge you to support our program that is designed to create millions of new jobs in the private sector in support of unemployed and underemployed people, who will be the major beneficiaries.

Representative RICHMOND. Why don't you take a good look at Lane Kirkland's program that was announced at the Bal Harbor meeting, the AFL-CIO program? I think it has so many brilliant ideas in it that we could really use in our current affairs. Have you examined it?

Mr. WEIDENBAUM. I did and the brilliant part escaped me. [Laughter.]

Representative RICHMOND. It's a lot more brilliant than the administration's program.

Representative REUSS. Senator Sarbanes.

ADMINISTRATION FORECAST QUESTIONED

Senator SARBANES. Gentlemen, you're all professionals by training and experience. Given that, I'd like to pick up off the closing paragraph of the chairman's statement, where he talks about "Given the economic realities that we face." And I'd then like to go to the table on page 2 with respect to the economic outlook.

Philosophy is one thing; facts are another. I'm concerned about the enormous gap that seems to exist between how you see the world, the economic world, and how many others see it.

What do you expect the real GNP to do in the first quarter of 1982?

Mr. WEIDENBAUM. Now, traditionally, councils of economic advisers do not, as you know from your own experience, if I recall, issue formal quarterly forecasts. That may be a limit of the state of the art. It may be sheer caution.

So I want to be responsive, but I hope you can keep that in mind.

Senator SARBANES. I'll respect that. Let me phrase the question differently. In this morning's Washington Post, pointing out the worst decline since 1975, as U.S. production drops 3 percent, Walter Heller and George Perry have revised downward their forecast for 1982. In a joint forecast released yesterday, they said the decline in GNP this quarter should come close to the last quarter's decline of 5.2 percent annual rate.

Would you take issue with that?

Mr. WEIDENBAUM. Oh, yes. I think that the decline in this quarter will not be as large as the 5.2-percent decline in the fourth quarter of last year. However, depending on the severity of the weather, and I'm not a meteorologist, by a long shot, I think that this will be the last quarter of negative growth.

Senator SARBANES. How much do you expect us to decline?

Mr. WEIDENBAUM. I don't have a specific number, but significantly less than——

Senator SARBANES. Do the other two members of the Council agree with that? What is their view on how the real GNP will move in the first quarter and the second quarter of 1982?

Mr. JORDAN. I think that within the second quarter, there will be a pattern of generally improving economic activity. A wide variety of monthly measures will show improvement within the quarter, and I think that, on balance, the second quarter will show a general expansion. As you know, not all industries move down at the same time, not all industries move up at the same time.

Senator SARBANES. Do you expect there to be a growth in real GNP in the second quarter?

Mr. JORDAN. Yes, I do.

Senator SARBANES. Do you expect a decline in the first quarter?

Mr. JORDAN. Well, that is partly a function of how we end the prior quarter. As you know, the way quarterly average data are gathered, and the way something like the weather affects the early numbers in January, pretty much determines quarterly average.

So you can have an expansion in February and March, which I fully expect, but that does not dominate the effects of the quarterly average. The first month of the quarter does. And I think that we have already seen the low point in this cycle and a general expansion is getting underway.

Mr. WEIDENBAUM. I think we all agree that the second quarter will be the turning point. We will see in the second quarter of this year the various indicators—not leading indicators, but coincident indicators—turning up.

Senator SARBANES. Will the second quarter show an increase in real GNP?

Mr. WEIDENBAUM. That is my current expectation, yes.

Senator SARBANES. By what amount?

Mr. WEIDENBAUM. Less than the 5-percent-plus that we anticipate for the second half. You can see the pattern. The fourth quarter of 1981, the period of deepest decline, less decline in the first quarter——

Senator SARBANES. Let me pursue those figures a little bit. As I understand your table, residential investment in 1981 declined 22 percent; is that correct?

Mr. WEIDENBAUM. That's right, in dollars. These aren't starts. These are dollars.

Senator SARBANES. And you expect it to grow in 1982 by 24 to 27 percent.

Mr. WEIDENBAUM. Yes, sir.

Senator SARBANES. You expect it to go from minus 22 to plus 24 to 27; is that right?

Mr. WEIDENBAUM. That's right.

Senator SARBANES. Now, nonresidential fixed investment grew 1.4 percent in 1981. And you expect it to grow in 1982, 6½ to 7½ percent; is that right?

Mr. WEIDENBAUM. Yes. You will appreciate, these are fourth quarter over fourth quarter figures, not calendar year over calendar year, as the table shows.

Senator SARBANES. Mr. Chairman, I'd like to include in the record at this point an article by Hobart Rowen.

Representative REUSS. Without objection.

[The article referred to follows:]

[From the Washington Post, Feb. 14, 1982]

REAGAN'S ECONOMIC PLAN COURTS DISASTER

(By Hobart Rowen)

Let's say it up front: President Reagan has presented Congress and the nation with an economic program that is irresponsible: its parts don't add up, its fiscal and monetary assumptions are contradictory, its expectations exceed credibility, based on historic experience, and it pushes the nation to the edge of financial disaster.

Last year Sen. Howard H. Baker Jr., the Republican majority leader, labeled the first Reagan budget "a riverboat gamble." This one is even worse: It shows that the president is out of touch with reality, transformed from the chief exponent of balanced budgets to the biggest deficit-spender in history.

Over the five years fiscal 1983 through 1987, Reagan asked for authority to spend \$1.644 trillion on defense. That works out to \$900 million *every day*, including Sundays, for those five years. George C. Wilson, the Washington Post's veteran Pentagon reporter, uncovered an estimate (the one that prompted lie-detector tests) that the real bill would be closer to \$2.4 trillion. That works out to more than \$1.3 billion every day.

Can the nation afford this kind of excess?

"No clear economic rationale exists for the persistence of deficit spending year after year," the Congressional Budget Office notes. The president pokes fun at liberals who—he says—are suddenly deficit-conscious. But earlier budget problems "pale by comparison with the problems that face the country today," the CBO adds. Moreover, there is nothing in Keynesian doctrine that endorses chronic deficits in a period when the private economy is supposed to be strong.

On the stump in Minnesota, the president last week assailed "paid political complainers" who challenged his budget. And in his hortatory and highly defensive budget message to Congress, the president paused to lambaste "the voices of doubt, retreat and rejection [that] are beginning to rise."

He failed to mention that prominent among those doubters, who urged an adjustment in his policy, were Treasury Secretary Donald Regan, OMB Director David Stockman, White House advisers James Baker and Ed Meese—in fact, the entire White House inner circle except for domestic policy assistant Martin Anderson (who since has resigned).

As conservative economist Rudolph Penner observed, it's not unusual for presidents to make optimistic predictions. What's different this time is that "he [Reagan] doesn't have a margin for error." In the long run, Penner points out, former budgets always showed a big surplus. But Reagan, with a $750 billion tax cut over five years, and the staggering military budget, has wiped out the ability of the economy to generate a surplus for the foreseeable future.

Reagan thus has staggering budget deficits penciled in as far as the eye can see (even assuming he gets what he wants from Congress). The budget never reaches a balance—according to Stockman, it won't be possible until sometime beyond 1988.

President Reagan ignored his own team's advice to raise tax revenue. But that would have been an admission that last year's supply-side tax cut was too big. So Reagan "held" the budget deficit to a "mere" $91 billion for the coming year not only by claiming $56 billion in "savings" that a dubious Congress is sure to reject in large part, but also by adding in $39 billion in revenues reflecting a brisk recovery that is virtually impossible in the face of higher interest rates that have the economy in an exhausting bind.

This is more than the cosmetic fix-up of budget numbers that presidents Johnson, Nixon, Carter et al. practiced from time immemorial. It is based on a rigid commitment to an ideology that brushes aside reasonable questions and demands adherence to Reagan's economic faith in the simultaneous application of a stimulative tax cut and a restrictive monetary policy.

"Fears that the upturn will lead to a sharp upswing in interest rates and choke off recovery, while understandable on the basis of previous history and policies, are unjustified in the light of current policies and the administration's determination to carry them through," says the Economic Report of chief economic adviser Murray L. Weidenbaum.

Isn't this more of the same bland assurance given last year, that if the public has faith in Reaganomics, the program will work? Weidenbaum was asked.

His response: "The sooner the public sees all of the elements of the program work their way through the economy, and understands that the economic environment of the '80s is going to be different from the years that preceded, the sooner the public sees this, the sooner the adjustments will be made."

That's not very convincing. The president promises the kind of rapid economic growth that liberals and conservatives alike reject as dream-world stuff—given current high interest rates. In an unguarded moment, even Treasury Secretary Regan, when asked at the National Press Club how the recovery could proceed in the face of high interest rates, mumbled under his breath: "That's a good question."

But good soldier Regan, beating the drums for the budget as proposed by the president, labeled as "conservative" the estimate for real economic growth averaging 4.7 percent 1982 through 1987, because it is lower than the 5.4 percent average recorded in 1961-66. What Regan failed to point out was that in the 1960's neither the administration nor the Federal Reserve of that era was in bondage to a strict monetarist from pointing out the internal inconsistencies of the Reagan forecast.

The AEI's William J. Fellner, for example, hoping against hope that the administration will eventually "do the right thing" by raising taxes, pointed out to reporters that the Reagan prediction of more than 10 percent growth in the average value of the Gross National Product over the next five years doesn't square with his prediction for declining inflation at the same time.

"We've never had an expansion [of nominal GNP] like this when it wasn't during an inflationary period," Fellner said.

If the Fed keeps money growth rates to its 4 percent target of this year, the only way for nominal GNP to get up to 10 or 11 percent is for money to churn over faster in the economy, at a 6 or 7 percent rate. The technical word is "velocity." This is twice as high as the average for the past 28 years, and exceeds even the highest peaks recorded in single years.

"If we get a big increase in velocity," Fellner said, "then the Fed should tighten up, instead of going along with an increase in nominal GNP. This [inconsistency between the Fed's restrictive money policy and the high GNP growth forecast by Reagan] leaves me with a feeling of uncertainty."

You don't have to be an economist—merely a cynic—to figure out that the administration needed to have a big nominal GNP in its tables in order to "collect" enough tax revenue to make it appear that the budget deficits won't be even worse.

The Economic Report does not contain the monetary policy assumptions for 1983 and beyond. And Weidenbaum refuses to say what velocity rate the administration's budget and other projections depend on. But he promises that enough velocity will be there, and insists there can be an economic expansion without inflation, while interest rates are falling, and the money supply growth is steadily decreasing.

Most observers outside the administration just don't believe Weidenbaum. They argue that high interest rates are inevitable, in the face of the deficits projected, as business competes with the Treasury for available funds. The White House rebuttal is that there will be a huge "pot" of savings in the private sector—supplemented by investment funds from abroad—with which to finance the enormous federal deficits, along with business demand.

The financial markets don't believe it. Neither does Fellner. He pointed out that even if the administration gets its program through Congress, and even if the nominal GNP balloons as forecast, the relative drain of the proposed deficits to the net amount of savings would about equal past records. And those records were set when the economy was in an advanced stage of recovery—an environment the Reagan team used to criticize as dangerously inflationary.

Regan and the rest of the team players are now saying that big deficits won't cause a run-up in interest rates—which will come down as inflation comes down. But that's what the Reaganites promised last year, and it didn't work: Reaganomics I was a bust.

So here we are at Reaganomics II. The promise that its supply-side tax program would pay for the huge military build-up and yield a balanced budget with low interest rates and reducted inflation having bombed out, Reaganomics II abandons the goal of a balanced budget, but stubbornly clings to a huge tax cut and hawkish commitments to the Pentagon.

Lyndon Johnson found out that he couldn't have guns and butter without inflation. Ronald Reagan can't have a $750 billion tax cut and a $1.6 trillion military build-up at the same time. The nation is in desperate need of Reaganomics III, which will give up something of one or the other. If Reagan won't write a new script that way, Congress must.

Senator SARBANES. It is entitled "Reagan's Economic Plan Courts Disaster." And I'd like to quote the first paragraph of it:

> Let's say it up front: President Reagan has presented Congress and the Nation with an economic program that is irresponsible: its parts don't add up, its fiscal and monetary assumptions are contradictory, its expectations exceed credibility, based on historic experience, and its pushes the Nation to the edge of financial disaster.

Now the budget projections include about $40 billion in revenues that would ostensibly come from this tremendous upsurge in economic activity; is that correct?

Mr. WEIDENBAUM. Yes, sir.

Senator SARBANES. If that upsurge doesn't happen, the deficit problem will be compounded; would that be correct?

Mr. WEIDENBAUM. Yes; but I recall a year ago being criticized for a rosey scenario for 1981. In 1981, it turned out that we underestimated the growth. We overestimated the inflation. We overestimated the unemployment.

So I think the first time at bat we demonstrated we are on the cautious side. We didn't claim too much.

Senator SARBANES. You told us about the expectation for the policy, that policy would produce immediate results.

Mr. WEIDENBAUM. I never said that. I said that 1981 would be a soft and soggy year. I said that from the outset. I never said immediate results.

Senator SARBANES. As distinguished from other members of the administration?

Mr. WEIDENBAUM. I have a long-term policy of not commenting on the comments of my colleagues. That increases my productivity about 20 percent. [Laughter.]

Senator SARBANES. Can I ask how often you meet with the President to discuss economic policy as the Chairman of the Council of Economic Advisers?

Mr. WEIDENBAUM. I'm in meetings with the President, typically, many times in a given week, sometimes many times in a given day. It will vary. I also provide, at his request, of course, a steady—I won't say barrage—flow of information, material, analysis.

Representative REUSS. He's a good reader.

Mr. WEIDENBAUM. There's a hard literacy requirement at the White House. If that's what Congressman Rousselot is referring to.

REAGAN PROGRAM ASSUMPTION ABOUT MONEY VELOCITY

Senator SARBANES. Now what do you think of Mr. Fellner?

Mr. WEIDENBAUM. Mr. Fellner is a distinguished economist, former president of the American Economic Association, someone who I often agree with. Not universally, of course.

Senator SARBANES. He says that the prediction of more than 10 percent growth in the average value of the GNP over the next 5 years does not square with predictions of declining inflation at the same time. "We've never had an expansion of nominal GNP like this when it wasn't during an inflationary period," Fellner said.

He points out that the velocity of money to meet all of these targets would have to be twice as high as the average for the past 28 years. In this article, Mr. Rowen then says:

> You don't have to be an economist, merely a cynic, to figure out that the administration needed to have a big nominal GNP in its tables in order to collect enough tax revenue to make it appear that the budget deficits won't be even worse.

What's your response to that?

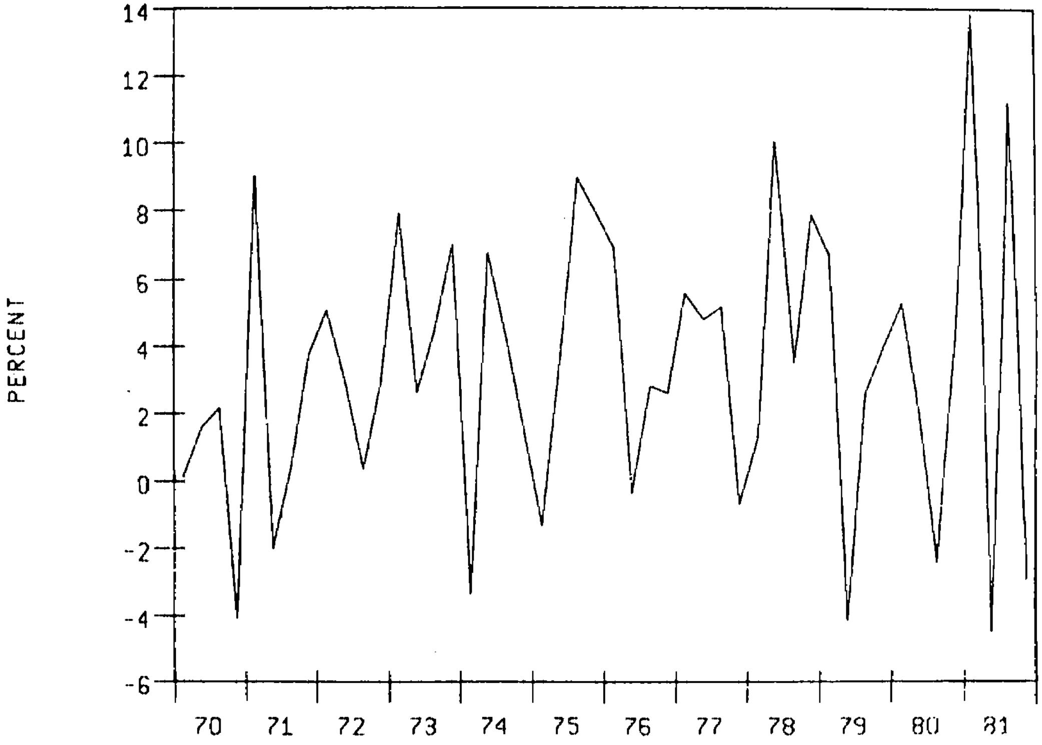
Mr. WEIDENBAUM. First of all, I find it instructive that the attention to velocity tends to ignore, and I'd be glad to make this chart available for the committee——

Representative REUSS. Without objection, it will be received at this point.

Mr. WEIDENBAUM. If someone would take it up to the Senator, I'd be grateful.

[The chart referred to follows:]

VELOCITY
ANNUAL RATE PERCENT CHANGE



DATA ARE QUARTERLY 1970 TO 1981:4

Mr. WEIDENBAUM. As you can see, to say that velocity over the years has operated like a yo-yo may not be terribly far from merely describing what's happening. Now we have maintained a tradition in the past of not projecting monetary growth or velocity; that is, private scholars, such as Professor Fellner, are free to make their estimates of what monetary growth path and what velocity accompanying that growth path would be anticipated in connection with our nominal GNP figures. We forecast nominal GNP.

You will notice nominal GNP after this recovery declines steadily. The growth rate of nominal GNP declines steadily. This is our fundamental basis for anticipating continued progress on inflation.

Senator SARBANES. Do you think it's reasonable for you to assume with respect to velocity——

Mr. WEIDENBAUM. It's going to be higher than the average.

Senator SARBANES [continuing]. That its going to be twice as high as the average for the past 28 years and exceed the highest peaks recorded in single years. Is that a reasonable premise?

Mr. WEIDENBAUM. I do not think that we'll make any new records in the computations that I have seen, and you have to, as I say, make assumptions as to precise monetary growth paths. But, quite clearly, we will not be necessarily hitting, much less exceeding, for an extended period, peak velocity of past years.

CRITICISM THAT REAGAN BUDGET AND ECONOMIC FIGURES AREN'T REALISTIC

Senator SARBANES. Mr. Chairman, I see that my time is up. I simply want to close with this observation. In the article that I inserted in the record is the following statement with respect to the various economic numbers that the Council is laying out before us:

> This is more than the cosmetic fixup of budget numbers that Presidents Johnson, Nixon, Carter, et al. practiced from time immemorial. It is based on a rigid commitment to an ideology that brushes aside reasonable questions and demands adherence to Reagan's economic faith in the simultaneous application of a stimulative tax cut and a restrictive monetary policy.

Gentlemen, I really appeal to the professionalism in you when I suggest that we're in deep trouble if we can't get figures to work with that, as you say in the closing paragraph of your statement, "adhere to the economic realities that we face."

No objective outsider took your budget when you submitted it and your economic program and said, "That's a game plan for the future." Leave the Democrats out of it. Leave the politicians out of it. Leave the Congress out of it, even though it's the people on your own side of the aisle that express distress. Take the objective observers in the economy. They didn't see it as a game plan that would work the economy out. They can see the internal contradictions.

James Schlesinger has written that not projecting much bigger deficits on the basis of what you all are putting forward is unrealistic.

Mr. WEIDENBAUM. I would like to request that Mr. Jordan answer that. But I would like to point out that Professor Rowen is a fine journalist, but I do not take him as a peer in terms of economic analysis, as you appreciate.

Senator SARBANES. You can put down Bart Rowen that way, if you want. You've got a lot of other extremely able people telling you exactly the same thing.

Mr. JORDAN. Senator, if I might respond, our nominal income projection for 1982 and the assumption for 1983, by coincidence, are right in the middle of the range projected by the Congressional Budget Office. Their range goes considerably higher than our numbers. Other top rank forecasters—Data Resources, Chase Econometrics, Townsend-Greenspan, Wharton Economic Associates, Professor Kline at the University of Pennsylvania—all have higher nominal income growths in 1983 than the administration. A year ago, there was a problem with communication between the administration and the Congress over having varying economic assumptions. It turned out that our economic assumptions were much better than the Congressional Budget Office.

Senator SARBANES. What are the assumptions on inflation to which those nominal growths are related?

Mr. JORDAN. Last year, the Congressional Budget Office——

Senator SARBANES. No, no, the CBO assumption on inflation, related to the nominal figures you've just given me, is not as optimistic as yours, are they?

Mr. JORDAN. They have a range that surrounds ours on both real output and on inflation. And in terms of putting together a budget, it's the nominal income growth that matters. As far as having a dialog with the Congress on economic policies and programs, we have a set of assumptions——

Senator SARBANES. The consistency between their projection on the nominal growth and the inflation expectation, over their range, is better by far than the consistency that you're projecting with respect to those two figures.

The point we're trying to make is the inconsistencies within the economic framework that you're projecting.

Mr. WEIDENBAUM. But Senator, you question our nominal GNP growth, which for 1983 is 11.5 and CBO's is 11.9.

Senator SARBANES. That's related to your inflationary expectations. It's no answer to say that your nominal GNP growth compares with someone else if their inflationary expectations are not as optimistic as yours.

Mr. WEIDENBAUM. I suggest on the basis of performance, that we are a creditable source. In 1981, as I said, our first year at bat, we didn't overestimate progress on inflation; we underestimated progress on inflation.

Senator SARBANES. No, I'm talking about the consistency of what you're projecting right now. No one is looking at your figures and accepting them as being a realistic view of the economic situation. The consistency of the comparisons you're trying to make is much stronger in terms of their internal framework than yours is.

Mr. WEIDENBAUM. I don't acknowledge that, Senator. First of all, if you take the real growth that we projected for the recovery period, it averages 4.8 percent. If you take the real growth for the recoveries in the post-World War II period, it averages in excess of 5 percent.

So we are below the average for real growth during post-World War II recoveries.

Senator SARBANES. You keep slipping off of it. Mr. Chairman, to underscore this point I'd like to insert in the record at this point a table showing economic forecasts, 1982 to 1986, containing the administration's, the CBO baseline and the DRI, which I think makes the point I'm making, that the internal consistency between their various projections is clearly more realistic, I think, as most observers would see it, than the ones being made by the Council.

Representative REUSS. Without objection, it will be received.

[The table referred to follows:]

TABLE I-2.—ECONOMIC FORECASTS, 1982-86

[Percent changes, unless noted]

	1982	1983	1984	1985	1986
Real GNP growth (annual averge):					
Administration	0.2	5.2	5.0	4.7	4.4
CBO baseline	−0.1	4.4	3.6	3.5	3.5
DRI	−0.7	4.1	3.5	4.7	3.7
GNP deflator:					
Administration	7.9	6.0	5.0	4.7	4.6
CBO baseline	7.5	7.3	6.6	6.0	5.7
DRI	7.5	7.7	7.2	8.4	7.3
CPI:					
Administration	7.3	6.0	4.6	4.8	4.6
CBO baseline	7.5	6.9	6.9	6.4	6.0
DRI	7.6	7.9	7.6	7.8	7.6
Unemployment (annual average):					
Administration	8.9	7.9	7.1	6.4	5.8
CBO baseline	8.9	8.0	7.4	7.2	6.9
DRI	9.2	8.3	7.6	7.0	6.6
91-day T-bill rate:					
Administration	11.7	10.5	9.5	8.5	7.0
CBO baseline	12.0	13.2	11.3	9.4	8.7
DRI	11.7	11.6	10.9	9.9	10.4
Budget deficit (fiscal year; dollars in billions):					
Administration	$98.6	$91.5	$82.9	$71.9	$66.0
CBO baseline	$109.0	$157.0	$188.0	$208.0	$234.0

INCONSISTENCIES IN FORECASTS OF RECESSION END

Representative REUSS. Mr. Weidenbaum, in the Economic Report which came out 8 days ago, it was said on page 209, "The current recession is expected to end early in 1982." Yesterday, Budget Director Stockman, testifying before the Budget Committee, testified that the economy will start to come out of the recession in summer or fall. Has the administration changed its position in the last week?

Mr. WEIDENBAUM. No, sir.

Representative REUSS. How can you explain the inconsistency? Or doesn't Mr. Stockman speak for the administration?

Mr. WEIDENBAUM. He was providing his personal views. I am defending the estimates. It is our expectation that late spring, early summer, depending, very frankly, on the progress that we make in bringing down those high interest rates, that the upturn will be visible.

Representative REUSS. Well, have you ever known Mr. Stockman to be wrong?

Mr. WEIDENBAUM. Dave Stockman's a mortal man. Mortal men err on occasion. He is very mortal.

EFFECT OF REAGAN'S PROGRAM—QUICK OR LONG TERM?

Representative REUSS. On another subject, you say on page 3 of your prepared statement, Mr. Weidenbaum, "Since the administration——

Mr. WEIDENBAUM. What page are we on?

Representative REUSS. On page 3 of your prepared statement this morning.

Mr. WEIDENBAUM. Thank you.

Representative REUSS. "Since the administration's economic policies are designed to increase long-term economic growth and to reduce inflation, they were not expected to have immediate favorable effects."

Now you've testified, in response to a question by Senator Sarbanes, that you never made such a statement and I fully accept your exculpatory answer.

On March 10, 1981, President Reagan, in his message to Congress, said, and I quote: "Our tax proposal will, if enacted, have an immediate impact on the economic vitality of the Nation, where even a slight improvement can produce dramatic results."

Are you suggesting that the President was deliberately trying to deceive the American people?

Mr. WEIDENBAUM. Oh, not at all, and let me give you the hard evidence of the accuracy of the President's forecast. In the first three quarters of 1981, the personal savings rate averaged 5 percent. In the fourth quarter of the year, the quarter following the enactment, the effective date of the first installment of the tax cut, the savings rate rose to 6 percent. From 5 to 6 percent increase in the personal savings rate.

And it's quite clear that savings was one of the key objectives of the tax program. There you have as rapid a response as anyone could expect.

Mr. JORDAN. If I may, Mr. Chairman——

Representative REUSS. If I could just interrupt, Mr. Jordan. When the tax bill was passed around August 1, there were 2 million less unemployed than there are today. Do you call that a great burst of economic vitality?

Mr. WEIDENBAUM. No, I would not call that a great burst of economic vitality. Mr. Jordan.

Mr. JORDAN. I was going to make a comment about the President's proposals a year ago. He had proposed a 10-percent personal tax reduction effective July 1, of last year. As we know, it was only 5 percent beginning on October 1. We had a significant continuing inflation last year, even though it was coming down slightly. For the year it was even less than we said it was going to be. Real taxation rose significantly in 1981, and it will not be until July of this year before we have a real tax cut for the American taxpayer.

GOLD COMMISSION DECISION TO ISSUE A GOLD COIN

Representative REUSS. Thank you. On another subject, I alluded earlier to gold and to President Hoover's infatuation with it. I was very happy to see in your report, pages 69 to 73, an excellent refutation of the gold myth. I congratulate you on it. You point out that in the heyday of gold, there were greater fluctuations in inflation and growth and higher unemployment than at other times. I read that 8 days ago and was very pleased and reassured.

However, I was astounded Friday, when, before the Gold Commission, you Mr. Weidenbaum, and you, Mr. Jordan, as members of the Gold Commission, provided the two crucial votes in an 8 to 6 decision of the Gold Commission to ask Congress to authorize the minting of a gold coin, which, unlike the Kruggerand and the Maple Leaf and other pieces of gold, would be entirely exempt from the capital gains tax. The stock market is a shambles. What we need, I suggest, is the restoration of confidence in the stock market.

If somebody buys a high-technology, high-productivity common stock and makes a profit on it, be must pay a 20-percent capital gains tax on that profit. If your recommendation goes through—and I tell you right now, I'll fight it as hard as I can—if that goes through, why should anybody invest in common stocks when he can invest in a Government gold piece, and when the price of gold increases, as it inevitably will because it's fluctuated vastly in the last couple of years, escape a capital gains tax?

Why did you do a thing like that?

Mr. WEIDENBAUM. As someone who does not own any gold coins——

Representative REUSS. I was not suggesting personal skulduggery in any way. [Laughter.]

Mr. WEIDENBAUM. That is a relief. [Laughter.]

My concern, very frankly, was that those who do purchase gold coins be encouraged to purchase U.S. gold coins rather than Kruggerands, Maple Leafs, and other more exotic versions. But having seen the value of gold plummet from approximately $800 an ounce to $400 an ounce. I really don't view this as a major source of investment.

If our citizens, our residents of the United States want to buy gold coins, I think that they should have an adequate opportunity to buy them from our Treasury.

Representative REUSS. Why did you and Mr. Jordon make that recommendation?

Mr. WEIDENBAUM. I can't speak for Mr. Jordan.

Representative REUSS. Well, let's hear from you and then we'll turn to your colleague.

Mr. WEIDENBAUM. I assure you, in terms of my vote, this had nothing to do with the gold standard. It was just recognition of reality, that Americans, to some degree, are buying gold coins. They should have adequate opportunity to buy American gold coins.

Representative REUSS. Were you unaware that an administration favorite, Senator Helms, has been plumping for such a capital gains tax-free gold coin for sometime now?

Mr. WEIDENBAUM. We play no favorities.

Representative REUSS. Just answer the question.

Mr. WEIDENBAUM. Sir? Was I aware that was the Senator's position.

Representative REUSS. Senator Helms.

Mr. WEIDENBAUM. I don't recall. If I had that information, it certainly was not a factor in my vote. I make up my own mind.

Representative REUSS. When did you make up your own mind?

Mr. WEIDENBAUM. When I filled out the questionnaire that the committee circulated, in the privacy of my office, with Mr. Jordan, if I recall, the only other person present.

Representative REUSS. Had you, before that time, conferred about your vote with any other administration figure?

Mr. WEIDENBAUM. Never on any subject before that Commission.

Representative REUSS. You weren't in touch with Secretary of the Treasury Regan on this point?

Mr. WEIDENBAUM. No, there is no administration caucus, I assure you.

Representative REUSS. Well, would you just answer the question?

Mr. WEIDENBAUM. I did not know in advance how Don Regan would vote. He didn't know in advance how I would vote.

Representative REUSS. Mr. Jordan, yours was the other critical vote.

Mr. WEIDENBAUM. By the way, the acid test here is check how Mr. Jordan and I voted. You will find as eminently sensible economists, we generally agree, but we occasionally disagree in our voting on the Gold Commission.

Representative REUSS. Mr. Jordan, why did you do this thing?

Mr. JORDAN. Well, in response to your last question to Chairman Weidenbaum, I didn't even know that Secretary Regan was going to vote, let alone how. I think attention to the section of chapter 3 that you referred to is deserved. We think that we have a set of policies that will reduce inflation over time, but we think that the American public needs to engage in a dialog about how do we insure that inflation will stay down once we get it down? And I was very impressed by the analysis done by the Treasury Department about some of the costs of the current capital gains taxation of gold coins or gold medallions. There's also balance of payment implications if the American people want to own pieces of gold, to import it from abroad, rather than from our own gold stock.

I think that Congress, by at least considering the issue and letting some of the analysis that was done by the Treasury Department have greater exposure, can help to inform the American people on some of the costs and benefits both of change in policies or continuing with the present policies.

Representative REUSS. Yes, but you voted for it. You didn't just ask Congress to consider it. You voted to recommend it. In fact, you provided the crucial vote, together with your associate, Mr. Weidenbaum.

Mr. JORDAN. Because I think that congress should consider it because I think that the process that's done in congressional deliberations and hearings is educational.

Representative REUSS. Well, should we consider it favorably and further torpedo the stock market and productive capital investment by putting another loophole in the tax system? Do you recommend that?

Mr. JORDAN. I'm not convinced at all that it would torpedo the stock market. I think that that question needs to be raised and developed. That there were a lot of things that have been considered.

For example, other measures to encourage saving, and investment, and the concern that you mentioned about the inpact on real investment and common stock.

One of the things that has been done recently by Congress in the name of promoting savings, I think may have been counterproductive. What we wanted to do in that section of the report was to say that there have been problems in the past with the way that the gold standard operated, so people now have other proposals. There are proposals about monetary rules. We have no answers or policies to recommend to these at this time. We want to continue the discussion, both with the American people and with Congress, to come up with a set of policies to insure that once we have eliminated inflation, we have institutional arrangements to insure that price stability is maintained.

Representative REUSS. Well, if all you wanted to do was to continue discussion, why didn't you simply recommend that Congress continue to consider, as I'm sure Senator Helms would have us consider every day the granting of a Bunker Hunt type loophole to gold speculators? Why did you recommend that we enact such a crazy law?

Mr. JORDAN. Not that it be enacted, but that Congress hold hearings to consider the enactment of this, as well as a number of other things we recommended Congress consider during the discussions on Friday. It was all in the vein that this is a congressional Gold Commission, making the recommendation that Congress consider certain proposals. And my attitude on that whole Commission has been that nothing we do is binding. All we are doing is recommending that Congress continue to consider certain types of proposals that we think would be instructive.

Representative REUSS. Well, you're backing down on this now and I'm glad you are backing down. It discloses the fraudulent nature of those Gold Commission recommendations. It turns out that you didn't intend, you've just testified, to recommend to Congress that we issue a tax-exempt gold coin. You just wanted us to discuss it.

Mr. JORDAN. I may recommend that. I may come down on that side. I was very interested in the Treasury study which said that having the so-called capital gains taxation is costing the Treasury money because people make deductions when gold prices go down, but they don't always reliably and honestly report when gold prices go up. Therefore, an end to the capital gains taxation might save the Treasury some money. I thought that that was very informative. And I haven't made up my mind. But I think it is important that that discussion continue.

Representative REUSS. Well, it's interesting that the caster of the decisive vote now tells us that he hasn't made up his mind. I would nominate the Gold Commission for the theater of the absurd award of the year.

Turning now to——

Mr. WEIDENBAUM. I suggest that each voter was the marginal voter.

ASSISTANCE TO THE POOR

Representative REUSS. Turning now to another topic, on page 43, at the top of the page in the Economic Report, you point out that things like public housing, food stamps, and medical care are, in a phrase that Herbert Hoover used to love, "inefficient." And then you go on to say: "Poor people, given money, can best determine for themselves what goods to buy."

Well, I don't think that that statement is all bad. It has a lot to be said for it. It evokes memories of Pat Moynihan's and Nixon's negative income tax, of George McGovern's "Demogrants." But where in the President's program are you giving all this money to poor people? You persuaded me, but I don't find a line item in the budget on this.

Mr. WEIDENBAUM. First of all, this report is designed to be instructive. I'm glad that you take it in that light and I hope that all of our readers take it that way. That was our effort, to strive as best we could for economic analysis.

Now it turns out that the great bulk of assistance, of the income maintenance category, is in the form of cash. Not all of those outlays are in the form of cash. And yes, we provide some economic analysis to help you evaluate that.

I hope you take it in that spirit.

HARM TO PRODUCTIVITY CAUSED BY RECESSION

Representative REUSS. On page 114 of the Economic Report is a discussion of productivity, a subject, as you know, of great bipartisan interest to this committee. But I don't find anywhere in your discussion of productivity any mention of a factor which this committee finds to be a tremendous inciter of a good productivity performance; namely, operating the economy, not at the pathetic level of 70 percent of industrial productive capacity, which it's limping along under nowadays, but at a much more realistic rate, thus spreading the fixed costs over a larger number of units and increasing productivity.

Any reason why that wasn't mentioned?

Mr. WEIDENBAUM. Well, first of all, before I turn to my colleague, Mr. Niskanen, I'd like to point out that fundamental to the entire Reagan program is increasing the growth rate of the American economy, and that's a subject that is so very amply treated throughout this document.

In this chapter, we are dealing with some of the more specific measures that have more specific impacts on productivity. But I find nothing to quarrel with your basic notion, and I share your view that restoring the growth of this economy will be a very positive factor in restoring productivity.

Representative REUSS. Mr. Niskanen.

Mr. NISKANEN. Mr. Weidenbaum is entirely correct in pointing out that a lot of our productivity problems are a consequence of stop-and-go policies, of policies that the taxpayers, consumers, and workers cannot count on over a period of time, and highly volatile fiscal and monetary policy in the past. A very large part of the theme of this report has been to try to get away from stop-and-go policies and provide a stable policy environment in which individuals can make their own economic decisions.

This particular chapter focuses in on the longer term contributions to productivity, but I don't think it's appropriate to charge the report for failing to address the problems of stop-and-go policies. A very large part of the report addresses this as a problem.

DISCUSSION OF ROLE OF GOVERNMENT IN ECONOMY

Representative REUSS. Surely. In the opening pages of your Economic Report, you attribute the stagnation and inflation and unemployment, the declining performance of the American economy over the past 15 years, to the growth of the Federal Government and its role in the economy.

Mr. WEIDENBAUM. The page, Mr. Chairman?

Representative REUSS. It runs throughout. I'll ask staff to busybody through the report and give me a page citation. But I don't misrepresent your views, do I? Aren't you against grossness and bigness in government, and for a smaller——

Mr. WEIDENBAUM. Yes. I'm against grossness, bigness, baldness, all those things.

Representative REUSS. Good. Well, while staff scavanges a reference, how do you account for the fact that, when the Federal Government was lean in the administration of Herbert Hoover, that things were so badly managed that we got into the Great Depression? That was a small government.

Mr. WEIDENBAUM. I could say before my time, but I was in diapers at the time. My memory is a little hazy. If one of my colleagues wishes to respond, not that that indicates that they are of greater age, just of more information.

Mr. NISKANEN. Mr. Chairman, I think it's important to focus on what has happened during the postwar period. The rapid growth in the money supply beginning in the mid-1960's has been associated with both higher inflation and higher unemployment. Rapid growth in all kinds of programs to assist workers and jobseekers and so forth has been associated with higher unemployment and, unfortunately, particularly higher unemployment among minorities.

Back in the 1950's, for example, the unemployment rate among minorities was a good bit lower than it is now. These programs have not proved to be effective in accomplishing those aims that people may have intended. It is not so much that they have enormously contributed to those conditions, as they have not been effective in correcting those conditions to which they were intended.

Going back to your early remarks in comparing Mr. Reagan and Mr. Hoover, if our program is moderately successful, we will be successful in bringing the role of the Federal Government back to the period of about John Kennedy. Let me remind you that in 1965, we had about 18 percent of GNP channeled through the Federal budget, about 7 percent of the GNP specifically for defense.

If we are fortunate in achieving all of our budgetary and economic objectives, we will not quite meet the conditions prior to the Vietnamese war. This was a period of time in which inflation rates were 2 percent, unemployment rates were 4 to 5 percent. The Federal Government was a substantially smaller share of our output than it is at the present time.

I think that the conditions that existed under the Kennedy administration are worthwhile and commendable targets for the policies of the Reagan administration.

Representative REUSS. Yes, staff has now provided me with those citations with which I love to embellish whatever I say. See pages 27, 28, 29, and 37, passim. How do you like that?

Mr. WEIDENBAUM. I'm duly impressed.

Representative REUSS. But particularly on page 37. "This chapter has summarized the theoretical reasons for a limited role of the Federal Government in the economy," et cetera, et cetera, et cetera.

PROJECTED DEFICITS AND NEED FOR A TAX INCREASE

One last question, Mr. Weidenbaum. There is a widespread feeling among responsible Republicans in both the Senate and the House that the Congress will have to produce some kind of a tax increase this year in order to reduce the horrendous 1983 projected deficit. I'm well aware of the President's position on this. But if Congress wanted to raise revenues substantially this year, let's say in the $20- to $40-billion range, what revenue-raising measures would you find the least objectionable?

In other words, if we can make you happy and do the right thing, I'd much sooner make you happy.

Mr. WEIDENBAUM. I'm pleased to call the chairman's attention to the revenue-raising measures contained in the fiscal 1983 budget.

Representative REUSS. Right. But the Republicans are talking about something far, far bigger and somewhat different. So outside of what's in the budget, and we'll stipulate that you're for that——

Mr. WEIDENBAUM. But that's my concern.

Representative Reuss. If our Republican leaders in the Senate who wear the pants, if they come forth with an alternative program, what kinds of initiatives by those Republican leaders would be the least objectionable to you?

Mr. WEIDENBAUM. As an economic adviser to the President, I don't think that it would be appropriate for me to suggest to others alternatives to the President's program. I strongly welcome the growing attention on both sides of the aisle in both Houses of Congress—the entire administration does—we welcome the growing attention to the serious problem of restraining outlays and curtailing the deficit.

I urge you to focus as much as you can on the expenditures side of the budget. As someone who is intimately involved in the review of the appropriation requests of the various departments and agencies, I'm always reminded of Harry Truman's famous dictum: He never saw a budget that couldn't be cut.

So I urge your attention, rather than to increasing taxation—the tax burden is quite high, as history points out, by any standard—to the expenditure side of the budget.

As Mr. Niskanen pointed out in his statement a moment ago, any substantial reduction in spending will still mean that we devote as a nation a larger share of our GNP, of our economy, to

Government spending than through most of American history, until just a few years ago.

Representative REUSS. And I would reply to your nostalgic reference to Harry Truman with one very similar, which has a little bit of Will Rogers in it. I've never met an economic adviser I didn't like. And that applies to you three gentlemen. You've given us an interesting morning. Thank you very much for your patience. And we will now stand in recess until tomorrow when we shall look at the effects of the Reagan program on the cities.

Mr. WEIDENBAUM. I would thank the chairman and in regard to Mr. Sarbanes' earlier question, I hope that I'm not too late for my meeting with the President.

Representative REUSS. Splendid, because I've suggested a couple of things that you can whisper into his ear.

So we will now stand in recess.

Mr. WEIDENBAUM. Thank you.

[Whereupon, at 12:10 p.m., the committee recessed, to reconvene at 10 a.m., Friday, February 19, 1982.]

THE 1982 ECONOMIC REPORT OF THE PRESIDENT

FRIDAY, FEBRUARY 19, 1982

CONGRESS OF THE UNITED STATES,
JOINT ECONOMIC COMMITTEE,
Washington, D.C.

The committee met, pursuant to recess, at 10 a.m., in room 2154, Rayburn House Office Building, Hon. Henry S. Reuss (chairman of the committee) presiding.

Present: Representatives Reuss and Mitchell; and Senator Sarbanes.

Also present: James K. Galbraith, executive director, Louis C. Krauthoff II, assistant director, Betty Maddox, assistant director for administration; William R. Buechner and Deborah Matz, professional staff members.

OPENING STATEMENT OF REPRESENTATIVE REUSS, CHAIRMAN

Representative REUSS. Good morning. The Joint Economic Committee will be in order for a continuation of its annual hearings into the President's economic program.

We are privileged this morning to welcome a strong panel, including representatives of our cities and the students of our cities. The staff is to be commended for producing a broad spectrum. We welcome Mayor Joseph Riley of Charleston, who I believe is a regular Democrat—a southern Democrat.

Mayor RILEY. Very regular.

Representative REUSS. Mayor Schaefer of Baltimore, who is a progressive Democrat. Would that include you?

Mayor SCHAEFER. I don't know what I am.

Representative REUSS. And our old and esteemed colleague, Bill Hudnut, mayor of Indianapolis, who, when I knew him, was a conservative Republican, and I guess still is.

You all have been outstanding mayors of your cities. You have seen the American cities generally and, in particular, your own Charleston, Baltimore, and Indianapolis, defy the critics of 15 or 20 years ago who said that the American city was on its way to being a scrap heap. You have shown us in your own way that the city was capable of great regeneration, and the question before us this morning is: How are you doing, and what do you see on the road ahead, and how we on the Joint Economic Committee can benefit from the academic world?

We have two gentlemen who have been of great assistance to this committee and, in a previous incarnation of mine, in the Subcommittee on the Cities, you were both—you, Professor Bahl of Syracuse and Professor Nathan of Princeton—always ready to help us, and I'm delighted to have you with us today.

Before starting the panel, let me say that we have your prepared statements, and, under the rule and without objection, they will be included in full in the record.

Now, I would like to call upon Senator Sarbanes for his special welcome.

Opening Statement of Senator Sarbanes

Senator Sarbanes. Thank you very much, Mr. Chairman. I am pleased to welcome the panel here. Mayor Hudnut and I are old friends, undergraduates together in days long gone by. Mayor Riley, I guess that's a blessed name in South Carolina, isn't it, it seems to me?

Mayor Riley. It's catching on.

Senator Sarbanes. So I see. And the few people here from the academic world, Professor Bahl and Professor Nathan—are from my alma mater.

I particularly want to take a moment to welcome Mayor Schaefer. I live in your city, Mr. Mayor, and so I think I'm in a position to speak from firsthand knowledge about the extraordinary leadership which you have provided Baltimore. Mayor Schaefer is now in his third term as mayor of the city. Before that he was president of our city council and before that a councilman. Much has been made of Baltimore's renaissance now. I think it's a prime example of the ability of an older city to renew itself and bring back a spark of vitality that we have always associated with urban civilization. But such renewal doesn't simply happen, and it calls above all for the very skillful, committed, and dedicated leadership of a mayor and other public officials.

Mr. Chairman, I just want to say we in Baltimore, with any disparagement of the other mayors here this morning, think we have the best in the country. I am very pleased that Mayor Schaefer is with us this morning to share his own perceptions and observations with the committee and with the Congress.

Representative Reuss. Since I have been treated with great courtesy and hospitality in all three cities in my day, I suppose I won't make any judgments, but I do have to say I share your great admiration for your hometown.

All right, gentlemen, Mayor Riley, would you kick off, please.

STATEMENT OF HON. JOSEPH P. RILEY, JR., MAYOR, CITY OF CHARLESTON, S.C.

Mayor Riley. Thank you all very much, Mr. Chairman, Senator Sarbanes. I greatly appreciate this opportunity to testify briefly before you this morning and appreciate the leadership that both of you have given for the cities of our Nation in the Halls of Congress. I have submitted a prepared statement for the record, but would prefer this mirning just to speak informally and briefly for a few moments.

The favorite story of Chinese baseball is being bandied around right now, and its fits, the difference in Chinese baseball which, as you know, is in American baseball we move the ball and in Chinese baseball they move the bases. To understand Chinese baseball you need to keep your eye on the bases. I think it's important now in the discussion of the budgetary issues and new Federalism that we don't get locked into an agenda or a dialogue and be unable to watch the bases, or to stand back and maintain an historical perspective of the needs and role of cities in our country.

Question: What has changed in terms of needs of our cities in the past year or year and a half? What has happened to take us from a nation that has just forged a national urban policy into a nation where the leadership says we need no national urban policy? What has happened? What has changed factually?

Nothing has changed. I resent personally and from an historical perspective the fact that mayors are often thrust into the role of begging, asking for charity for our cities. We are rather asking for what is our due. Someone has written recently that we are a nation of great wealth at the national level and great poverty at the local level, and, as luck would have it, everybody lives at the local level. [Laughter.]

As a nation, we ask our cities to house, support, and to provide services for the institutions of culture that are a part of it. We as a nation ask our cities to house, support, and provide services for the institutions of education which are vital to us and neither of which pay any taxes. We ask and demand our cities to provide services for our hospital complexes which pay no taxes. We ask and demand our Nation's cities to provide housing for the poor that moved in from the rural areas to our cities as a part of the great caravan that occurred in the 1940's, 1950's, and 1960's.

We ask our Nation's cities to provide a park system, playgrounds, and open spaces for urban America. We ask our cities to provide spaces for the churches, auditoriums, and concert halls. We as a nation expect our Nation's cities to provide that and at the same time we are told that we must repair the pockmarked central business districts; we must restore the rundown residential neighborhoods; we must rebuild our infrastructure which Nation's Business said 6 weeks ago was one of the critical problems facing our country. And yet we are now being told to do it with our own resources.

Telling our Nation's cities to rebuild themselves with their own resources is no different than asking someone who has lost an arm to grow it back on their own. It simply won't happen. The obvious facts that impelled our Nation's Government—our Federal Government—to develop urban strategies, those facts haven't changed, Mr. Chairman. The facts are that the wealth of our Nation moved from the cities to the outlying areas. If you think back and the next time you go—whether it's in Baltimore, Philadelphia, Chicago, or one of our older cities—and look at their institutions that were created 50, 60, 70, 80 years ago, you see the obvious marks of a wealthy government back then that had the resources because cities were self-contained. They are no longer. Because of what has been recommended and passed in the 1983 budget, it very severely constricts the ability of my city to meet our needs.

We are very proud of the housing restoration projects that we have in our city, block by block, border by border. Yet from 1976 to

1982 the costs of housing rehabilitation in my city doubled—doubled. The community development block grant—the quintessential block grant, the New Federalism which was given to us just a few years ago, has shrunk by about 40 percent adjusted for inflation. Section 312 we used to rebuild apartments, and provide housing for the aged and for the infirmed, is gone. Our CETA program is being cut. We have used this program very effectively, particularly title VII, to work with the most innovative new programs in the part of our city that is plagued with extraordinary high pockets of unemployment. We used it to work with the Control Data Corp. and their inner-city venture, and as a result we are going to provide about 1,500 new jobs for the unemployed and structurally unemployed. Without title VII, it would not have been possible.

The urban parks recovery program now gone, was once a hope to rebuild the old urban spaces in our country. The Land and Water Conservation Fund, quintessentially; the block grant automatically went back to the States and in our State 50 percent of it went to the local governments for them to set priorities. We rebuilt 16 playgrounds in our city. Now that program is gone. Public housing maintenance has been cut.

Finally, Mr. Chairman, on the issue of the New Federalism we all at this table, certainly the mayors support more responsibility. We don't back away from that. We pick up our garbage, we answer citizens' complaints. We are the closest level of government responsibility. That's nothing new to us, and we welcome it. But those programs that fit into that dialogue of the New Federalism—revenue sharing, community development, block grants—are proposed to come back to us and in a few years the resources to be pulled away.

The city of Charleston has already had invested $16 million in private investment in a program that went with $8 million worth of UDAG funds, 1,600 new jobs. Without the ability to generate that critical mass, through New Federalism, the resources eventually will be taken away, and that capability of cities is gone. The urban parks program again gone. Land and water conservation, CETA, Mr. Chairman, as of now proposed is not a sorting out of responsibilities, giving what we can back to the local level; rather it is sending us responsibilities but eventually removing the national resources that we alone can't generate to do the job, and in rebuilding our cities it is going to be essential that we have continued strong federally shared resources.

And that is simply, Mr. Chairman, a way of allowing the city of Charleston to get the support from the entities that are 20 and 30 miles out that wouldn't be there but for our hospitals, but for our colleges, but for our universities, but for our art museums, but for our symphony, but for the essentials of an urban nation. But for what they have in the city of Charleston and that wealth—that generated wealth capability—wouldn't be there. The existing Federal partnership enables us to garner some of that generated wealth and have it put into the institutions that make my area and make every metropolitan area a place worth living.

We have not, in conclusion, Mr. Chairman, asked for the Federal Government to do our work. Only to share the resources. We will do the difficult work. Perhaps our generation's most challenging domestic job. But we will do the planning, we will do the consensus building. We will do the neighborhood redevelopment. We will do the backbreaking work. We will take the risk and we will take the flap. We ask only in rebuilding our cities block by block, house by house, neighborhood by neighborhood that the wealth of this great Nation continues to be shared with the cities of this great, great Nation.

If we don't do that, if the New Federalism as proposed sends back additional responsibilities but with no resources—and getting back to the Chinese baseball, getting back to the broad historical perspective—we will have something that 20 or 30 years from now is completely indefensible—a nation of wealth and strength, an urban nation—the most urban nation in the world abandoning its urban institutions.

Mr. Chairman, we ask that you and this committee continue to provide the leadership to enable the cities of our country, with the help of Federal resources, to do the work that we, as the locally elected public officials, are most willing to do. Thank you very much.

[The prepared statement of Mayor Riley follows:]

PREPARED STATEMENT OF HON. JOSEPH P. RILEY, JR.

I appreciate the opportunity to speak to you this morning about the New Federalism and the effects of the proposed Fiscal Year 1983 Federal Budget on the City of Charleston.

The basic problem, I believe, is that the Reagan Administration does not have an urban policy. The urban programs now threatened by the proposed 1983 budget are the result of a developing and learning process stretching over the last three decades. This process has produced a notable number of successes, both nationwide and in my city of Charleston.

Federal grants from the Department of Housing and Urban Development have enabled us to rehabilitate nearly 350 housing units, through Community Development Block Grant funds and Section 312 monies. Eight million dollars in Urban Development Action Grant funds will create 1600 new permanent jobs, more than 60 million dollars in new private investment, and will be the catalyst for downtown revitalization. The Land and Water Conservation Fund and the Urban Parks Program have helped us to renovate or construct 16 parks in the city.

These successes are, however, but a beginning. Much, much more remains undone. I know that mayors are accused of chronic complaining at this time every year, but look at our problems. Cities do not have the tax base or the income to meet their needs. America is an unusual nation. At the national level there is great wealth, at the local level--great poverty; and as luck would have it, everyone lives at the local level. The taxing ability of cities is severely limited by the states. Hemmed in by the suburbs and the flight of residents and economic development, cities have watched their infrastructure deteriorate. Urban decay is a national problem and national resources will be required to rebuild our cities.

The dilemma facing you is two-fold: the short-term impacts of the proposed 1983 Fiscal Year Federal Budget and the long-term implications of the New Federalism.

In Charleston, our Community Development Block Grant has been reduced for the past two years by a cumulative rate of 38%, adjusted for inflation. These cuts can perhaps be better viewed in concrete terms. Renovation of a housing unit on the City's depressed East Side cost $12,000 in 1976. This same renovation would cost $24,300 in 1982. Yet our Community Development funds are being cut. Revenue Sharing funds have bought increasingly less over the last ten years.

Without the CETA Title VII program, the City of Charleston could never have afforded the innovative City Venture program that has attracted a major investment on the East Side by the Control Data Corporation and will provide 1,500 new jobs in that depressed neighborhood during the next five years.

Are these efforts and a dozen others to be dropped? My city does not have the resources to pick up the full costs of these initiatives.

As for the New Federalism, I see nothing wrong with trying to sort out responsibilities among the federal, state and local levels of government. Yet the federal level must make the resources available to the cities to meet our responsibilities.

We took you at your word over the last few years that you would forge a national urban policy to use the wealth of our nation to see that our cities did not die.

We did not ask you to do the work but only to share the national resources. We will do the back-breaking work--the planning, the consensus building, taking the risks, struggling to stay in the black. We at the local level were willing to do perhaps the generation's most difficult task, to rebuild our nation's cities--house by house, block by block, neighborhood by neighborhood.

The pledge to the nation's cities has been broken, the faith has not been kept. We, as a nation, can afford huge tax breaks to big oil companies, but we cannot help rebuild our cities. How will history view that policy a hundred years from now?

Representative REUSS. We are off to a very strong start. Thank you, Mayor Riley. Your suggestion when you said that as some scientists, you know, talk about the greenhouse effect caused by the burning of fossil fuels and the leak of carbon dioxide into the atmosphere and pointed out that if we allow that to get out of hand, the Antarctic ice cap might melt and Charleston, Baltimore, and our other great cities of the east coast would be 30 feet under water.

I take it what your suggestion is, that even without such a greenhouse effect, if the Government of the United States defaults on its obligations to keep our strong cities, they are going to be under a similar kind of drowning water.

Mayor RILEY. Exactly, Mr. Chairman.

Representative REUSS. Mayor Don Schaefer.

STATEMENT OF HON. WILLIAM DONALD SCHAEFER, MAYOR, CITY OF BALTIMORE, MD.

Mayor SCHAEFER. Mr. Chairman, I hope you will grant me the latitude of being able to wander around for a bit. First, Mr. Chairman, let met thank you very much for inviting me over. I listened to the mayor of Charleston and he almost said it all. I'd like to call your attention to a number of things.

First, why am I here? Your invitation asked me to discuss the fiscal condition of the city of Baltimore, what our problems are, and what that New Federalism means.

I appeared here in March 1981, and I came over not with the intention of saying to you or to anyone everything that's proposed is wrong. I didn't come over for that. What I came over for was to tell you what would happen to cities like Baltimore, if the Federal budget is cut.

What will happen to a city like ours? I said that I was for reduced spending, I want to reduce the deficit and reduce the interest rate, want to involve the private sector, I want to do all those things and all those things are important. But I also wanted to call to your attention what would happen to the poor, to the handicapped, to the unemployed, to the senior citizens in our city and every city in the United States similar to Baltimore. And I was received and listened to, but I don't think the impression that I wanted to make was there.

But what has happended since the time that I come over a year ago? One, the weakened safety net that was proposed. What does that mean, in so many words? A 25 percent cut in the basic programs, health, summer jobs, medicare, child care, and education. Two, a severe blow to our economic development initiatives, direct loans, loan guarantees, and IRB's. All of the things that were necessary to keep a city like ours moving. Like the mayor said, the initiatives that we had in moving our cities to successful cities are being cut.

I also said that there would be a tremendous loss of purchasing power in the Baltimore metropolitan area—about $350 million. How can that come about? You know, when you have a job, when you are secure, you really don't have to worry too much. But within a couple of months 3,000 public service employees that were doing productive work were let go. When you look at the total United States, and you say well, it's only 3,000. But that's 3,000 people that were working, taking care of families, taking care of mothers, older people, whatever it might be, and they are putting money in the economy and they are gone. And since that time, more and more of those people have been laid off and the jobs are lost. This is of great concern to me.

I suggested when I was here that when you change direction you've got to know what the outcome will be. All of a sudden we're going along in one direction and a complete and radical change occurs. Overnight, people are out of jobs, day care centers changed and closed, EDA grants are lost, loan programs are lost. It is a complete change. And what we suggested was not quite so fast a cutback, a little bit slower if you have to. We can help you make those decisions from our experience.

We weren't listened to and a radical change was made which had a very severe effect on our city.

When I came over before I said I lived in a world of reality, and then I was showed where the city of Baltimore was. Mr. Chairman, you were very kind to us—and I talked about the things we have done with Senator Sarbanes and our congressional delegation from our State and all the aides. We took a city that had lost its pride and we built the city into what I think is a very fine city, a city that has concentrated efforts first in its neighborhoods and its people and then rebuilt the inner harbor and all the rest of these things that are called glamorous. But the beginning was in the neighborhood with people, and we worked hard to do that and we took our Federal money and our State money and we utilized it for the city, and we asked you to come down and take a look at what we did.

But I still live in a world of reality. Baltimore city houses most of the poor, most of the unemployed, most of the disadvantaged, most of the handicapped, most of the senior citizens that need assistance, and we are surrounded by a very wealthy county. The poor are confined to the city, and that has not changed. If anything, it's more so right now.

Let's look at the world of reality in 1982: 45,000 unemployed, up about 2,000 or 3,000 from the last time I was here; 40,000 minority youths out of work, black youngsters; 40,000, up about 15,000 from when I was here before; and 138,000 public assistance recipients dropped due to tighter eligibility, but some of the people need help. All of the people are still there; 44,000 seeking subsidized shelter. When I say seeking subsidized shelter, we provide the public housing for people. The counties don't provide it. The counties are perfectly willing to let the city do it, and we don't mind doing it, if we have the resources to do it.

All of a sudden, if you take away the ability for us to provide housing, it won't be built in Baltimore County. Rehabilitation of subsidized housing, where are we going to get money for rehabilitating subsidized housing?

Let me tell you about the composition of the city in one other respect. One-third of the people pay taxes, one-third of the people pay some taxes. By some taxes, I mean they pay enough to pay the property tax and maybe educate one child. But if there are three children, someone else pays the taxes. And one-third are tax recipients.

I said to my county executive, why don't you help us out? And I pled and pled, and they said if you live in this world of reality, do you think we could go to our people and say we've going to take care of Baltimore City? Live in a world of reality; 27,000 unemployed insurance recipients, $2.8 million paid out per week on unemployment insurance recipients. If those people had been working in some respects, rather than $2.8 million being paid our per week it would have been better for employment.

And the last thing, the property tax rate that's $5.97. Now, remember what I said, one-third pay taxes, one-third pay some taxes, and one-third pay no taxes. The surrounding county tax rate is exactly $3.25. Our's is almost $6. And when you say send it back to the local area in order to let them take care of the poor, who are they? That one-third? That one-third is going to say goodby, I'm sympathetic, but I'm not going to pay a $10 to $12 tax rate in order to take care of the poor people.

And it slightly worries me. That's Baltimore City in a world of reality today.

Let me talk to you about private and public partnership—can it fill the gap? Anyone that thought in the very beginning that the private sector was going to be able to step in and say we're going to hire all the people, we're going to be able to do all this in a very short time, they weren't living in the world of reality. What you have to do is, you have to work with the private sector in order to fill the gap.

Let me cite just summer jobs. Two years ago we had 16,000 summers jobs. This year we'll have 5,000 in a city where there are 40,000 unemployed minorities alone. This year we're asking the private sector to come up with 1,000 summer jobs, and you're going to say to me that's a modest number. They wanted to come up with 600—and I'm not critical of the private sector, because in the city of Baltimore I think they're doing a great job. We're stimulated to get out jobs, so you go from 16 or 10 down to 5 and you add 1, and there's still a gap of a tremendous amount of young people that will be unemployed this summer. And you might say well, what difference does it make that the kids are employed or not? If you lived in a wealthy area where the families could be taken care of, it wouldn't make any difference. But I stepped out of my office one day and I saw a little girl at 5:30 and she said, "Mayor, I wasn't paid."

And I said. "Well, what difference does it make? Can't you wait until Monday?"

She said, "No, that money means that I'm allowed in my house."

It's the difference between living and not living. And you know, that made an impression on me. That really makes a difference as far as kids are concerned. They use it for clothing, they use it for helping their families, they use it for going to school the following year. And now these summer jobs you're talking about, with the high unemployment, are not beginning to compete with the people out of jobs. And when you're out of a job at my age, around 50—and I'm older—50 or 55, and I'm older than that—60, and I'm older than that—when you get to that age and someone says to you

you're going to go out and I'll help you, you know what I'm going to do? I'm going to get a psychologist for you, I'm going to to tell you what happens to you when you're 55 years of age and laid off. The first month you're depressed; the second month you want to jump in the bay; the third month you want to kill yourself, and that's not exaggerating.

What I'm saying, unemployment in cities like ours is very important. We lost $8 to $9 or $10 million in our public sector jobs. We asked the private sector to come in with the blue chips, pick up some of the programs. They did. They came up with $500,000 which is a lot of money from the private sector all of a sudden to be called upon to do. They came up with jobs in the public sector and they took on such programs as weatherization, reading for the blind, lead paint protection and all the rest. And what we did, we got the business sector and said: here are all the programs lost as a result of the Federal cuts. This is what we would like you to pick up.

And we got the business community to pick up some of it. We're going to get enterprise zones. We're one of the first cities that will have an enterprise zone that will qualify whether it qualifies under the Federal Government or not, because we are going to make our own enterprise zone. Foreign trade zones, we are going to do our own Federal foreign trade zone.

What I am trying to say is we are struggling in doing it, but we still need assistance from the Federal Government. You know what I said this winter to the cabinet, the people I have? You know what I said? Three basic things I want you to do: I want you to provide homes; I want you to provide warmth; and I want you to buy food for our people, and those are your priorities. Those are the priorities in Baltimore this year. Survival for people in need of food so no one in the city of Baltimore starved. And we did it. We provided for the first time an area for the homeless.

Mr. Standy over there, I told him you get me an old school, an abandoned school, and open up a homeless shelter for the people. Now, how long would it take the private sector to do that? Six or eight months. You know how long he had? He had 6 days and he opened it up, not to bring people other than overnight, just overnight. And he opened it up.

You know what our priorities for the summer are? Summer jobs. Get kids employed in the city of Baltimore. That's a high priority. Other programs like the adopt a family, where we say to poor families: if you tell us, we'll try to get a family to adopt you and we adopted 1,500.

Smoke detector programs where poor people weren't able to buy smoke detectors, we had 17 deaths in 21 days. We set up emergency shelters.

What's ahead? What's ahead for us? No new subsidized housing. Now, you might say, mayor, you have most of the subsidized housing in the city of Baltimore now. Why are you worried about more subsidized housing? There are 44,000 people on a waiting list for subsidized housing in the city of Baltimore, and I repeat, the counties will not provide it.

Slash the job training by 50 percent. More plant closings and massive layoffs as EDA and IRB's disappear. Pantry Pride is closed, Two Guys closed, General Motors cut back, Eastern Stainless Steel, Bethlehem, Chevron Chemicals, Sears, A. & P., Maryland Shipbuilding, the loss of more than 10,000 jobs. Now, the thing that worried me was the one thing that the President said last night. I'm not trying to be supercritical of the President. We were going on the presumption that the recession will be over in about a year or 18 months, and I said what do you do between now and the 18 months. Those people have not disappeared from South Carolina and Indianapolis; they're still there. But if that recession has no termination date, what do we do? What happens while we are waiting for that recession to terminate? And that worries me.

And we also find that transit fares will be increased for people getting to jobs; 85 percent reduction of food stamp, loss of 44 teachers of the handicapped, and more cuts to follow.

Another thing that worries me, take it to the State. Well, I don't know about other mayors, but if it goes directly to the State rather than to the cities, it's a disaster as far as the cities are concerned. And I have told everyone, including the President, that it's the wrong place to go. From my own experience, we will not have the political clout to be able to say that the programs will come to us.

Of the State poor, 65 percent are in Baltimore, 33 percent of the elderly, 45 percent of minority youths, 36 percent of unemployment. We are 18 percent of a total State population. Paul was one of my good friends in the State legislature, I remember him being there. We went through the State legislature. We will be competing with the rural areas. We will say we should get part of it, and it's absolutely essential that money come directly to the city and that the formulas be written in such way that they go to areas of need. There is no reason in the world for part of this money—Federal assistance—going to counties that do not need it. And the political reality is it will be distributed on a per capita basis, which will be a disaster as far as Baltimore City is concerned.

And I can tell you this because we had to go to court on education. That was a serious decision that I had to make and I went. OK.

What do we propose? We are not asking for a miracle. We are asking for a couple of things—ongoing Federal commitment to invest in people, human capital, people training the work force. Absolutely essential for cities like ours to have training for the work force.

I see our good Congressman is here, and he's heard this speech so many times he could make it for me. You must have a training of the work force. If an enterprise zone is to work, you must have a training component built in. There are people that live in our city that don't know what a job is. They have never had a job. They don't know they're supposed to work 5 days a week, and you say well, they're supposed to know that. I'm telling you, a training force is absolutely essential in expanding economic development in cities like ours. We've got to have special help as far as economic development is concerned because industry is only going to go to areas where there is a profit.

Delegating responsibilities directed to large, urban areas with the concentration of problems. Flexibility to do the kind of programs to fit local needs.

What I'm saying in so many words is our plight has not gotten better in the last year, and the cities should not be the only area of suffering. People in those cities need assistance and help, and the Federal Government can't just say we're going to get out of the business of caring for people. They've got to help areas like Baltimore where those poor are located.

My 10 minutes are up.

Representative REUSS. Quite a 10 minutes. Thank you very much.

Mayor Hudnut of Indianapolis.

STATEMENT OF HON. WILLIAM H. HUDNUT III, MAYOR, CITY OF INDIANAPOLIS, IND.

Mayor HUDNUT. Thank you very much, Mr. Chairman.

It's a pleasure to be here, along with my distinguished colleagues, to be invited to testify before the Joint Economic Committee during this most challenging time in government.

You asked what is happening now in terms of the impact of the administration's economic program. I am not going to elaborate greatly on what is happening in Indianapolis now because I have a prepared statement I would like to read into the record, although I would hope in the dialog perhaps some other things would come out.

You asked for our views on the new federalism and the economic recovery program of the administration.

I think it is important to say at the beginning that I support and applaud the President's fundamental and commendable goal of reducing the cost and size of the Federal Government. His approach has been twofold:

First, through the series of spending and taxing cuts proposed and approved by the Congress last year, to curtail the rapidly escalating outlay of taxpayers' dollars; and second, through what is now being called the new federalism, to restore balance to a severely overloaded intergovernmental system.

I would like to deal with the federalism issue first.

Lord Acton once described the genius of the American Constitution as follows:

> By the development of the principles of federalism, it has produced a community more powerful, more prosperous, more intelligent and more free than any other the world has seen.

As originally conceived, and as experienced in practice until recent times, federalism could be described as follows:

First, under authentic federalism, most government responsibilities were the exclusive province of the States which, in turn, delegated many responsibilities to local units of government. That, of course, promoted flexibility and experimentation.

Second, most of the decisions that directly affected the daily lives of the citizenry were made by those levels of government closest to them. The public was far more capable of, and diligent about, watching local and state officials, and the result was a meaningful participation by the public in the governmental process.

Third, the role of the Federal Government was limited to those matters which were generally considered to be national in scope, reducing the number of opportunities for the National Government to dominate the States and the people who live within them.

As we all know, things have changed a great deal since then. And while we can all agree that the category of responsibilities generally considered to be of national importance has broadened a great deal since Jefferson's time, it is also probably safe to say that most of the major complaints we hear about government today—that it is just too big, too bureaucratic, too arrogant, too inefficient; that it taxes too much, spends too much, and regulates too much—can be traced back to the withering away of a federalism in which governmental roles and responsibilities were more clearly defined and respected.

President Reagan is attempting to reduce the Federal overload by consolidating categorical grants into block grants; by returning authority and responsibility to State and local governments along with money, we hope, to pay for them, and so on.

Those efforts I support entirely in principle. And as a member of the President's Federalism Advisory Council, I hope to be able to contribute to the strategic plan that will be needed to get from here to there.

Of course, there are some obstacles in the way, not the least of which is the rhetoric currently making the rounds. Arguments that returning authority to State and local governments will restore "States rights" to its buzzword definition strike me as being unfair. Other protestations concerning "winners" and "losers" are at best premature, and based upon fear rather than on hard evidence.

Now, this is not to say that "new federalism" is without its challenges. Many of the fears expressed are, indeed, based on historic experiences, and as this process evolves in the coming months and years, care must be taken to insure as much as possible that the mistakes of the past will not be repeated.

Personally, I see at least three problems for the new federalism:

First, it may exacerbate the fiscal disparities problem—Mr. Schaefer alluded to this—which is to say it may favor the strong at the expense of the less strong, the Sun Belt at the expense of the Snow Belt. Who knows—yet? But I think your committee rendered a helpful service by flagging this issue, with your survey of 48 cities and your conclusion that it is those cities which have lost population in the last decade and are now suffering the highest levels of unemployment—for the most part, recession-plagued cities of the industrial Midwest and East—that have had their Federal aid cut most deeply, and are now being forced into the most painful tax increases, service cuts, or both.

Commonsense would suggest that if the new federalism is going to work, these inequities should be taken into account, adjusted for, and rectified. Governor Snelling of Vermont has suggested, for instance, that the new federalism be expanded to phase III, and that after 1991 a Federal trust fund be set up to correct any disparities. That sounds like an idea worthy of study.

Second, the new federalism will not work without strong State and local governmental cooperation. As you know, many cities around the country are of the opinion that they will not get a fair shake from State legislatures which tend to be dominated by more rural and suburban interests. We just heard Mayor Schaefer say this. But I hope that a new era in State-local cooperation is dawning, and I believe that the States are more sensitive and responsive to the needs of cities than perhaps they were in the past.

Nonetheless, the suspicion and mistrust of yesterday continue to be reminders today that a lot of work has to be done. The President has promised a mandatory "passthrough" mechanism to local governments of portions of the trust fund he proposes to set up beginning in fiscal year 1984, and we look forward to working with him, the Congress, the Governors, and the State legislators to write the language that will make that promise a reality.

As I said when I spoke to the National Governors Association last summer, we are all in the same boat together, so we had better start rowing together.

The third problem for federalism that I see has to do with political leadership—political courage or the lack thereof. Do State and local officials have the courage to make the tough decisions that lie ahead regarding whether or not to raise taxes to make up for Federal shortfalls or to eliminate some programing? Are we willing to tell the people who live in our cities and States that while we might all applaud reduced Federal spending and taxing, the result is likely to be either a reduction in local services or some increased local taxes? That is a question that has not yet been thoroughly analyzed, and I think in fairness to the people of this country, it must be.

For example, the city of Indianapolis is losing about $4 million of FAU money due to the cuts coming out of the Federal Government here in Washington. We have a taxing mechanism that is optional for us that we could put in place to restore that $4 million to our local DOT budget. We have 3,100 miles of streets and 660,225 chuckholes, at last count, that we are responsible for. But in order to enact the surcharge that has been authorized for us as an option by the State legislature, I need to get 15 votes out of 29 on the city council. I don't know whether that's possible or not because nobody likes to be saddled with raising taxes. So the result is, if we don't make up that shortfall, is to reduce services, that is, not to fill the chuckholes.

Let me turn now to the fiscal year 1983 budget proposal.

During last year's round of budget cutting, the cities, by and large, went along with the big cuts in aid from the Federal Government. We could not overlook the fact that, according to U.S. News & World Report direct assistance to cities had quadrupled in the 1970's and that some of the programs had not succeeded.

We feel now, however, that we have taken our fair share of the budget reductions. It's time to look elsewhere for further savings. Two-thirds of the first round of cuts last year, including social and human service programs, were taken by the cities. We are glad that in the current budget proposals, general revenue sharing, urban development action grants, and community development block grants are still alive. But we are distressed by the never-ending speculation that more cuts are yet to come. I would recommend that a great deal of thought be given to Senator Domenici's proposal to freeze Federal aid to State and local governments at fiscal year 1982 levels and establish a huge megablock program in lieu of categorical assistance.

Even more to the point, I think that is the time that the entitlement programs and the defense budget be given the same kind of microscopic scrutiny that urban programs have received—not to mention various kinds of subsidies, which is another question.

With regard to entitlements, the food stamp program rose 1,800 percent in the 1970's. Non-social-security entitlements have risen dramatically, from $8 billion in 1955 to over $180 billion currently. Federal civilian and military pensions are indexed to inflation at taxpayers' expense. Federal pension outlays, spurred by rising pay and cost-of-living increases, have more than doubled in the last 6 years—from $7.1 billion in 1975 to $17.6 billion in 1981, and are expected to hit $65.3 billion by the year 1999. And we cannot forget that the three social security trust funds have been losing money since 1974, and that they are currently losing $18,800 per minute, even though social security taxes soared by 2,011 percent between 1950 and 1980—four times faster than real wages and three times faster than the Federal income tax.

When President Johnson came into office, Federal spending on human resource programs stood at $34 billion, about 28.8 percent of the total budget; now, it is my understanding that 53 percent of current spending—almost $350 billion—goes for such programs. Ever since the New Deal, Mr. Chairman, the trend has been to boost Government-assistance programs, but those days are over. The train has got to be slowed down. We must stop going to Washington with a tin cup in our hands, always wanting more.

In my opinion, the time has come to deindex the benefit programs. Would it not be more fair, for example, to index some of these programs to the average wage increase during the year? Such indexing would have saved the Federal budget more than $10 billion, according to some calculations we ran in my office during fiscal year 1980. During 1980, while the CPI rose 13.5 percent, entitlement benefits rose 14.3 percent, or more than inflation, while the average person's wage increased only 9 percent. Figuring $2 billion per inflation point, that 5.3-percent differential amounts to $10.6 billion.

On the defense side of the budget, I have no quarrel with the notion that we must improve our military readiness, and I certainly would not want to be a party to giving the Soviet Union the wrong impression about our resolve. Nor do I have the expertise to know whether or not we should have a given weapons system.

I cannot understand why the price of 47 weapons systems rose by some $47 billion during a 3-month period, as they did in 1980. Nor can I understand how the Pentagon made purchases of nonweapons goods and services in 1980 totaling $30 billion without so much as taking a bid. The wisdom of tolerating rivalries among the armed services that costs billions annually and subsidies of lobbying for defense contracts that cost millions annually escapes me. And I cannot see how the Soviet threat retreated 1 inch when the Defense Department spent $500,000 to improve a bowling alley in Arkansas and another $500,000 to build a wet-bar at a base in Hawaii. I do know that those last two projects would have resurfaced 20 miles of pothole-filled streets in Indianapolis or any other city.

Now I know that many people are saying the Federal budget is being balanced on the backs of the poor, the elderly, and the handicapped, and I know that President Reagan has indicated very little flexibility when it comes to talking about the defense budget.

But the point is that we are never going to reduce the deficit or get the national economy going in the right direction until liberals start talking about capping the entitlements programs and conservatives start talking about capping defense. It's easy for liberals to support social service programs and criticize the military-industrial establishment and for conservatives to do the opposite. But not until conservatives honestly recognize that the Pentagon should be run on a more businesslike basis and that waste and mismanagement there should be curbed; not until liberals honestly recognize that ever-escalating entitlement programs will require outlays that the American economy will not be able to sustain; and not until these two groups engage in a responsible dialog and forge an effective bipartisan coalition, will we be able to disenthral our country from the debilitating effects of political rehetoric and focus on finding a solution to the grave fiscal problem of restraining the growth in government spending that vexes us all. Liberal claims that the President and conservatives are mean-spirited and insensitive to the problems of the poor, the needy, the disadvantaged and the elderly, are unfair, and so are the conservative allegations that any liberal who questions spending or demands accountability at the Pentagon is unpatriotic or "soft" on the Soviet Union.

All of us in government, at all levels of government, must learn to practice creative frugality. However, this process goes beyond mere reductions in spending and total taxes. It also involves what might be called the "weaning of America"—a process in which the people of this Nation reduce their expectations of government at all levels, stop looking to government for solutions to all their problems, and begin to take some of the responsibility for those problems upon themselves.

These are tough times. As a mayor who has to balance his city's books, I am troubled by the thought of deficits in the $90–$100 billion range—that's for the country and not Indianapolis. [Laughter.]

I also worry that such deficits are crowding out private investors who have the capability of rejuvenating urban America, and I wonder if those deficits and recently enacted protions of Federal tax policy are destroying the municipal bond market which needs to be healthy if urban America is to provide the infrastructure that economic renewal will need. Thoughts here in Washington—I have heard rumors about—of eliminating the tax exemption on municipal bonds frighten me even more and will make investors even more leery of investing in those bonds.

But in it all and through it all, I think it is important that we not lose hope. I have heard Mayor Schaefer say at the U.S. Conference of Mayors meeting in Louisville last summer that the cities are going to survive whether it's 10 percent less, 20 percent less, or 30 percent less. And he got a standing ovation.

The goals of the President's economic programs are to expand the private economy, bring down inflation and interest rates, and boost output and create real, not make-work jobs for the future. These goals cannot be achieved overnight. Many of our problems have been accumulating over a 50-year period and will not go away because the President or someone else waves a magic wand.

We must have enough faith in the future to try this approach and have confidence that, in time, we will be moving again down the path to growth and prosperity. Thank you.

Representative REUSS. Thank you, Mayor Hudnut.

Mr. Bahl.

STATEMENT OF ROY BAHL, PROFESSOR, MAXWELL SCHOOL OF CITIZENSHIP AND PUBLIC AFFAIRS, SYRACUSE UNIVERSITY, SYRACUSE. N.Y.

Mr. BAHL. Thank you. I would like to highlight some of the issues that I think are raised by the New Federalism and the administration's programs, just briefly.

It seems to me there are three premises behind the administration's programs. The first is that it is necessary for great amounts for defense; the second is that it is necessary to reduce taxes to stimulate capital formation and investment; and the third is that social service expenditures are nonproductive and really should not be allowed to contribute to a Federal deficit.

I think it is these three premises that lead to what we now hear as New Federalism, composed of the turnback and swap. The best interpretation of it is probably that you get government closer to the people. The worst interpretation is that the Federal Government really did not think through the reactions of State and local governments, and they are simply attempting to offload part of the Federal Government onto them. And if that's right, then the consequences may be quite severe for the administration's policy.

Either way, my reading of the administration program suggests to me it wasn't very well thought through. Not only do the numbers not appear to add up, but a lot of the consequences of the program don't appear to have been anticipated.

I'd like to talk about just four things: first, the consequences for income distribution in the economy; second, the consequences for regional competition within the country; third, city financial problems; and fourth, the question of the effect of the New Federalism on overall capital formation.

First, I would just like to say something about this question of the assignment of functions. Academicians have studied this for 100 years and haven't agreed very much on which level of government should supply which functions, with one exception, and the one exception is that pretty much everyone agrees that income transfers belong at the Federal Government level. If you move them down to a lower level and you attempt to subsidize low-income people with transfers then you attract low-income people to the community and drive away high income taxpayers that support these transfers, and it just doesn't work. It strikes me as strange that the cornerstone of the New Federalism really is to turn back the responsibility for at least a part of income transfers to the State and local government level.

On the question of income redistribution, I haven't seen good estimates of what the overall administration program means. The Federal tax cuts in the broadest sense, if they do what they're supposed to, are unlikely to be regressive. Certainly, we think that cuts in social services will have regressive impacts, particularly in the cities, but the overall effect depends on what the State and local governments do.

Now if the State and local governments respond by raising social service expenditures, if they're able to do that, then it will in some way offset the regressivity of the Federal program. But on the other hand, we will have substituted progressive Federal income taxes for that. We will have substituted more regressive State sales or property and even income taxes. So no matter how you cut it, there's a worsening of distribution of income. How bad, I think we really don't know.

The second issue is regional competition. We all know what is happening between the Sun Belt and the Snow Belt, that an increasing share of population, jobs, and income is moving out of the older regions of the country to the newer regions. We're just beginning to understand the implications of the comparative advantage of the resource-rich States and what they might be able to do to hasten that outmigration.

One policy might have been not to say that it should be slowed, that the sorting-out process probably has to occur, but that Federal Government has a responsibility to make the transition a bit easier. Indeed, the New Federalism, I think, would probably accelerate this outmigration. First of all, it raises a problem of the comparative disadvantages of central cities who will bear these cuts very heavily, and it would encourage a great deal of the industrial subsidies' policy that we have seen in recent years. I don't see how anyone could argue that that would be in the national interest.

Third, is the city financial problems issue. In the best of times this kind of program would have been tough on cities; but in a time of the recession when central cities are so hard pressed, it could be disastrous. We have learned a lot in the mid-1970's about what recession does, not just to the quality of life in a city, but to the budget of the city, and I know, Mr. Chairman, you have talked many times about estimates of revenue loss associated with recession in central cities. It also raises expenditures requirements substantially, and that's accelerated even more by the tightened eligiblility requirements for certain programs. So where is the relief going to be for cities over the next couple of years? Certainly, it's not going to be at the Federal level, because there's less aid, in general, and because the kind of safety net programs during a recession like this, like CETA, aren't with us anymore. In addition, there doesn't appear to be any kind of turn back program, because one doesn't see the Federal revenues for the turn back problems adding up to the same amount of money as the cities were getting before.

Maybe the cities could look to the State governments. But the State governments are going to be cut, and anyway the States don't have that good a track record in terms of allocation of money between central cities and suburbs. The more likely place that cities will look is to declining service levels further which they will cut back and to deferred infrastructure.

Another question raised with respect to cities is what about bankruptcy? Is it inconceivable that these kinds of cuts, combined with the recession, will push some cities to the edge, like we saw during the last recession in the mid-1970's? If that is so, what does the administration program suggest about dealing with bailout problems?

On the question of capital formation, just a couple of points. The administration program to reduce taxes is particularly geared to stimulating investment and increasing the rate of capital formation. Now the idea is that by various kinds of tax reductions and incentives, we can increase the rate of return to owners of capital. But what if the State and local governments react by picking up some of the slack and increasing taxes? At their disposal, they do have direct taxes on business, nonresidential property taxes and to some extent, income taxes, all of which could work to reduce the rate of return to owners of capital.

So in a sense, part of the whole supply-side argument could be dampened by the reaction of State and local governments—whether State and local governments do raise taxes or whether they don't raise taxes, and whether infrastructure investment is increased.

The administration would argue—and I think correctly—that it's important that State and local governments invest in roads, bridges, machines and plant and equipment is important, but isn't it also important that State and local governments invest inroads, bridges, ports, and public utilities? Don't we run the risk of creating some kind of bottleneck to increase productivity in the economy if we don't encourage investment by State and local governments?

The New Federalism and the administration approach does a couple of things. It gives less money to State and local governments, less discretionary money to spend for capital formation. The large deficit creates a credit squeeze which may squeeze many State and local government borrowers out of the market, and the interest costs are high, all of which suggests that there will be a substantial reduction in the rate of capital investment by State and local governments.

Finally, what about human capital investment? Didn't we learn somewhere along the way that there was some productivity associated with that? I have one good thing to say about the New Federalism that I read so far. Better than its predecessor, or in one way at least, it addresses the question of what will be the role of the various subnational units of government, and it seems to make the case that State government will be the key factor in the State and local government sector. It doesn't go very far in telling us what that means, and it doesn't have any provision to tell us how States should behave toward cities and toward suburbs, but at least it attempts to make the statement.

I think in general the problem with the New Federalism, as I have read about it so far, is that it says a great deal about the Federal Government, but it has very little to say about the anticipated reaction of State and local governments to this program.

[The prepared statement of Mr. Bahl follows:]

PREPARED STATEMENT OF ROY BAHL

The Administration's program to protect, restructure and stimulate the growth in the U.S. economy seems to be built on a few basic premises: heavy increases in defense spending are necessary to keep up with the Russians; Federal tax reductions are necessary to stimulate investment and capital formation in the private sector; and Federal spending on the social services is not productive and ought not to be allowed to contribute to Federal budget deficits and inflation. Together, the premises have lead to the newest Federalism, an emerging program which is aimed at transferring a larger share of the responsibility for delivering and financing public services back to the state and local government level. The new program is not spelled out in any great detail by the Administration, and some bothersome inconsistencies and ommissions seem apparent.[1] One wonders how much thought lies behind so bold an initiative as this.

I would like to address myself to the implications of this newest Federalism for the state and local government sector in particular, and for society in general. My view is that the societal costs of this program will be very great indeed. The distribution of income will be worsened, regional competition for jobs and resources will be encouraged, and a new round of urban crises could ensue. One result of these problems is that the chief benefit of the Administration program--increased investment and capital formation--may be considerably dampened by state and local government actions. Each of these issues is briefly discussed below.

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[1]The only information I have on the new Federalism is the Administration's release, "The President's Federalism Initiative: Basic Framework," (January 26, 1982).

THE ASSIGNMENT OF FUNCTIONS BETWEEN THE FEDERAL, STATE AND LOCAL GOVERNMENT LEVELS: THE ISSUE OF INCOME DISTRIBUTIVE SERVICES

Scholars and policy analysts have long been intrigued by the question of the proper assignment of functions between levels of government. Which functions of government should be the financial responsibility of which level of government, and where should decisions be made regarding the level and type of services delivered.

The conventional wisdom has been particularly clear on the question of who should provide income transfers. Distribution is properly a Central Government function. State and local governments cannot take on major responsibility for transfer programs aimed at improving the distribution of income. This is because tax bases (people and businesses) are mobile and may move to other jurisdictions to escape the burden of financing redistributive services. At the same time, low income families may move toward areas where subsidies are greatest or at least be held in those areas rather than migrating to regions where jobs might be more plentiful. To be sure, state and local governments do make decisions about taxation and the provision of services (such as education) which may have profound effects on the real income position of poor citizens, but few would argue that sub-national governments can maintain an efficient system of income transfers.

The actual trend in expenditure growth in the U.S. would seem to reflect a general belief that this reasoning is correct. A dominant trend in the American fiscal system has been the continuing increase in the budget claim of health, education, and welfare expenditures. The increase in public expenditures at all levels of government as well as the shift toward an increasing Federal share has been largely due to increased health, education, and welfare expenditures. At the Federal government level, the expenditure increases in the past two decades have been dominated by increased grants to state and local governments and increased Social Security expenditures. The trend has been quite dramatic. Combined Federal grants and direct expenditures for social welfare functions have increased from 66 percent of total Federal/state/local expenditures on those functions in 1950 to 78 percent in 1975.

The Administration's proposals would seem to both reject the notion that income redistribution is more properly a Federal than a state/local function and reverse the trend of the last 20 years. With respect to the latter, a clear implication is that an increasing share of spending for social services will occur at the state and local government level.

The Administration's program would appear to call for a $50 billion transfer of Federal programs to states over an eight-year phased transition. The major components of this program are a "swap" of Medicaid in exchange for state takeover of foodstamps and AFDC, and a "turnback" of approximately 43 Federal, social, health and nutrition programs. It is clear that the intention is to charge states with making the decision about the kinds of services to be delivered. The Federal program outlines a financing scheme to support the "turnback" in the early years and then assume increasing state financial responsiblity after 1987. The implication is quite clear: the Administration sees income redistribution as being an increasing responsibility of the state and local government sector.

IMPLICATIONS FOR INCOME REDISTRIBUTION

The Administration's programs will likely worsen the distribution of income in the U.S. I have not yet seen a thorough analysis of the impact of the Administration's tax cuts on the overall distribution of tax burdens, but one could believe that the distribution of these burdens is regressive. The cuts have come in the most progressive U.S. tax, the Federal Income Tax, and were structured so as to maximize investment incentives. Assuming that the Administration was able to properly design their system of tax cuts to achieve desired objectives, the distributional impact is almost certainly regressive. On the expenditure side, there is a substitution of defense spending for social service spending. Since most of the social cuts appear to be coming in health, education and welfare programs, with programs for the disadvantaged being hit especially hard, a regressive pattern of impact is assured. Such a program cannot but harm the distribution of real income in the U.S.

To the extent that some of these social service cuts will be made up by increased state and local government taxes, the impact on the tax system will also be regressive. The same is true even if the Federal government finances the turnback with excise taxes. In effect, we will have substituted state and local government sales, income, and property taxes, or Federal excise taxes, for Federal personal income taxes. I can think of no research that suggests such a trade would do anything but worsen the interpersonal distribution of income.

IMPLICATIONS FOR REGIONAL COMPETITION

For the past ten years there has been a growing competition among the states for jobs and Federal favors (e.g., Federal grants, direct Federal expenditures, favorable Federal regulations). The well-documented sun-belt-snowbelt shifts that have occurred during the past decade have fueled this competition. The states in the Southeast and Southwest have gained an increasing national share of population, jobs and income. Their representation in Congress has strengthened and consequently their share of Federal assistance is thought to have grown. On top of all this, there is the issue of the rising cost of energy and the comparative advantage of the resource-rich states.

Per capita personal income disparities have been narrowing at such a rate during the past ten years that most projections suggest a comparative advantage for the growing states of the Southeast and Southwest by the end of the century. The declining states' comparative disadvantage could be accentuated even more to the extent energy-rich states make use of severance taxes and export these burdens to the Northeast and Midwest. Moreover, reductions in Federal assistance could reduce public service levels in the Northeast and Midwest while driving up relative tax burdens in those states. It is interesting to note that after several years of substantial tax reduction, the Governor of New York is proposing a one percent increase in the retail sales tax to deal with the revenue shortfall.

In the face of these pending disparities and with national economic growth slowing, one response would have been for the Federal government to attempt a program to ease the transition for both declining and growing states. Instead, much responsibility has been turned back to the states and competition will be heightened. The temptation should be greater than ever for states to provide tax incentives to attract business. This could result in unnecessary revenue losses in the Northeast where resources will be especially scarce in any case. From a national perspective, there is little to be gained from competitive subsidies.

CITY FINANCIAL PROBLEMS

As several analysts have pointed out, the impact of the new Federalism will be particularly severe on large central cities in the declining regions of the country. Many will face substantial reductions in revenues--shortfalls that cannot easily be made up in today's economy. In a sense, these central cities are doubly-damned by the Administration's programs. First, their economies suffer dramatically from increasing national unemployment rates. These increases in unemployment have familiar effects on the public sector, i.e., social problems such as increasing crime rates are observed, revenue potential is off, the demand for social services is increased, etc. At the same time, these cities will be hit hardest by the Administration's cutbacks of social services. Traditionally, central cities have not been able to look to the state governments to provide relief for this problem. States may be even less sympathetic with city/suburb disparities now, not only because of suburban dominated Legislatures, but because the newest Federalism also shrinks the flow of Federal aid to state governments.

The Administration seems to have overlooked the implications of three particularly important problems. The first is that the problem of a deteriorating infrastructure could grow even worse. High interest rates, less discretionary revenues available for local and state government capital projects, and the need to use scarce resources to meet social service priorities all will work in the direction of continued postponement of capital construction and maintenance. Moreover, the substantial borrowing needs occasioned by Federal budget deficits will have severe implications for the bond market faced by state and local governments.

A second important problem, perhaps overlooked by the new Federalism, is what posture will be taken toward municipal bankruptcy? It would not seem reasonable to assign this problem to state governments at a time when state government resources are being reduced dramatically, but the Administration's philosophy gives every indication that state and local governments will be left on their own. An admittedly rough accounting of the funding involved in the "swap" and "turnback" programs suggests not only a restructuring but a substantial reduction in the total financing available. The hardest-pressed central cities may well be the hardest hit. This is indeed an uncertain area which ought to be addressed by national urban policy.

Finally, there is the question of the role of state governments. The Reagan Administration's program is to be applauded at least for facing the issue and apparently making a decision that state governments will play a key role in the Federal system. Moreover, to the extent that direct aid flows to local governments will be reduced, it seems clear that the intention is to place more and more responsibilities with the state. However, many of the implications of this decision have not been directly addressed. For example, what mechanisms will insure that state governments will act to deal with central city-suburban disparities, what will be the state responsibility in the event of bankruptcy or default, etc?

THE IMPLICATIONS OF FEDERAL TAX CUTS

The reductions in the Federal personal income tax were argued on a basis of increasing capital formation in the economy. However, the new Federalism proposals may offset some of those investment gains by inducing increased state and local government taxes. With Federal aid cutbacks as substantial as they are, state and local governments will likely respond by increasing retail sales, personal income, business, and property taxes. Certainly the increased income taxes on the highest marginal rate payers, increased business income taxes, and increased non-residential property taxes, could work to lower the effective rate of return to capital in some states. Moreover, the "price" of tax cuts to state and local governments will have risen as a result of Federal tax reductions, i.e., the deductibility benefits are now less valuable to Federal income tax payers because of their lower marginal tax rates. As a result, middle and upper income tax payers are able to pass a smaller share of every dollar of state and local government tax increases along to the Federal government, and are therefore more resistent to state and local government tax increments.

Another consideration is that public as well as private investment adds to the productivity of the economy. Is it not reasonable to believe that further deterioration of the capital infrastructure in urban areas--e.g., roads, public utilities, ports--can impede productivity increases? Could not a similar statement be made about investments in human capital, i.e., education and health services?

NATIONAL URBAN POLICY

It was pretty clear to most observers that the national urban policy of the Carter Administration did not address many of the important issues. In particular, the following were more or less ignored: whether the Federal government ought to attempt revitalization of declining areas or compensation for their losses during a period of financial adjustment; whether inflation and recession ought to be viewed as a part of intergovernmental policy; what roles should state governments play in the intergovernmental system; and what will be the Federal policy toward big city financial disasters?

The Reagan "new Federalism" seems to address one of these problems. It identifies the state governments as the key actors in the state and local government sector. On the other hand, the Administration does not go very far in spelling out the meaning of this role.

Like its predecessor, this Administration has not dealt with the other three issues. On the one hand, there are discussions of enterprise zones as methods of urban revitalization but no consistent policy regarding how to deal with regional disparities has emerged. Surely the Federal government has a major role to play in this area, i.e., the regional allocation of substantial increases in defense spending, the allocation of Federal grants, deregulation of energy, the method of taxing energy resources, etc.

Finally, the Administration is making no statement about intentions to compensate state and local governments for the effects of inflation and recession. Indeed, the Administration has increased the hardships on state and local government budgets associated with increasing unemployment. Unemployment compensation benefits have been altered to the detriment of local government areas with substantial amounts of unemployment, state and local governments will be left to their own devices to finance a larger share of welfare-related costs, and countercyclical assistance and public works programs have been eliminated.

Representative REUSS. Thank you very much.
Mr. Nathan.

STATEMENT OF RICHARD P. NATHAN, PROFESSOR, WOODROW WILSON SCHOOL OF PUBLIC AND INTERNATIONAL AFFAIRS, PRINCETON UNIVERSITY, PRINCETON, N.J.

Mr. NATHAN. Thank you very much, Mr. Chairman.

I would like to start off by quoting a line of Will Rogers. He once said, "Things will get better despite our efforts to improve them."

This is a quite grim period for urban public finance and for the economy. I have been before your committee before, and usually am very optimistic and bright and cheerful, but I don't feel that way today. So I start off on that note.

What I would like to do, Mr. Chairman, is to briefly mention research that we are conducting at Princeton University, and I have asked to insert a prepared statement that describes our research, rather than go into detail about what we are doing. We are conducting a national study of the effect of what we call the Reagan domestic program over the 4-year period 1981 through 1984. Rather than give you details, which are in my prepared statement, let me mention three figures.

We are studying 54 governments. We have 36 field researchers, economists, and political scientists, all around the country. And I am grateful to be able to say this for the first time because it's just been made public—we have received $908,400 from the Ford Foundation to conduct this research. The research is underway. It's been underway for about 3 months and it's too early for me to say very much to this audience about what we see as the results so far of the dramatic changes in American domestic policy by the Federal Government under the Reagan administration. But I would like to make a couple of generalizations by way of early ideas on my part of what I see from our studies, as we now have preliminary data from our 54 jurisdictions.

First of all, I think it's helpful to have a little framework of how you think about the effects of budget cuts. Budget cuts can affect cities in four ways. They can be ratified, that is, the city can say we're not going to make up the money and whatever program is cut, we're going to cut that program or that service or to be that person off of welfare or food stamps so that the cut is ratified and the private sector becomes bigger and the public sector becomes smaller.

A second thing that can happen is that you have what I call a compounding effect, which is that a local government or a State not only ratifies a cut by making that cut, but compounds it by cutting deeper into the same service.

A third thing that can happen is what you would call a replacement effect; that is, that a State or a local government can replace the cut.

A fourth thing that can happen is that they would augment the service that is cut and actually increase spending for it.

As you can see, the first two are negative for the domestic public sector and the second two are positive in terms of State and local services, if you want to look at it that way on a balance sheet.

What I think I can tell you so far, Mr. Chairman, is that the first two definitely prevail; that what we are finding and what I think we are going to find quite consistently in our studies is that the cuts that the national Government has made are being ratified, that the services and the benefits are being cut by State and local governments.

The second thing that I can say is that we already see some of what I would call this compounding effect, and let me give you two hypotheses. One hypothesis is that when the Federal Government cuts, that State governments will plunge in and will make up these services and give leadership or that local governments will do the same. And another hypothesis is that if its popular to cut in Washington, it's going to be popular to cut out there in the State and in local jurisdictions.

What I think we are finding so far—and this is tentative—is that there is more mimicry in the system than there is a kind of leadership response. That is to say, there are more "We'll cut the same thing and show you we can do it, too" reaction than there are reactions in terms of picking up the service and putting up more money at the local and State levels into what the Feds have cut.

The second point I did make as a general point so far about the cuts that had been made in the reconciliation act last year, is the cuts have more effect on people than they do on government, more effect on food stamps, AFDC, medicaid recipients, than they do on the treasuries and governments, and that the big effect is on the working poor and that you could generalize and say the most affected by the cuts made so far in the Reagan domestic program are poor people and poor cities, poor governments.

Let me say a word about poor cities and the way in which its been discussed here—by poor, I mean fiscally poor, hard-pressed cities that are having a very hard time providing the basic services that city governments provide.

What we are finding is that something called dependence—Federal aid to dependents, being hooked on Federal aid works like this. If you're a hard-pressed government, you're fiscally troubled, you take every dollar you can get, including those Federal aid dollars, and you put those Federal aid dollars as best you can by all kinds of very subtle, sophisticated, and legal tactics, into the services that city governments are supposed to provide—their basic services. If you are better off and more conservative, you take those Federal grants and you put them off to one side and you say we don't want to have these Federal grants mixed up in our treasury because those guys—those people in Washington, pardon me—are so unpredictable they'll change the rules and they'll pull back the money. We don't want to be tied to those Federal aid dollars. We don't want to have strings going that way, so to speak.

What I find in our research is that the cities with the most serious problems are going to be the most affected in terms of their vital function, affected by these cuts because they are the ones who are dependent behaviorally, that is, they use Federal aid money to keep body and soul and vital services together.

Mr. Chairman, if I could very quickly make two other points. One is I brought a table with me today that we printed out last night at 9 o'clock, and this shows in a most wonderful but elaborate way how current services in 1983 and 1982 are affected by the Reagan program. This is a new table that will be part of our analysis base line, which will be published as a book in about 6 months, and I am offering a prize today to anyone who can understand it. If anyone would like, I will go through and explain it, but I have not time in my 10 minutes to do anything but say I have a new table and it shows just what I said is true, that the cuts have been and continue to be predominately in the welfare program areas and in social program areas that affect primarily people. But certainly in a larger setting or in a larger way, the poor and particularly the working poor.

And the budget says that. I'm not telling you something that is a secret. It's right in the budget. I can read to you in the budget where, in chapter 6, page 27, in a very nice way, very technical but clear way, the President says exactly what I just told you.

Finally, I was invited in your letter to say something about swaps and turnbacks, and I want to say something very quickly on the New Federalism swaps and turnbacks. Roy Bahl said that experts have been working on turnbacks and sorting out functions for 100 years. I think he was referring to me. I have been working on this for 100 years.

To pick up on what Roy said, let me say I agree with everything he said, and I would like to quickly make a proposal. I think there is a much better way to sort and turn back that would have the following four elements: First of all, food stamps ought to stay right where they are. I don't see why food stamps shouldn't continue to be primarily federally financed and structured for policy purposes. I don't understand why that's in the package.

Second of all, the swap ought to be between AFDC and the turnback program. But the swap ought to work in the following way: We ought to move on what Professor Bahl said is the historic path we have been on of more national responsibility for income transfers by gradually phasing in more Federal responsibility for AFDC and, if that costs money to the Federal Government, they would then cut back turnback programs to even out that exchange. And let me say that's good, conservative philosophy. I think a Republican—a conservative—would say if you believe in the market, people ought to vote with their feet. And if you want people to vote with their feet and go where the jobs are, you can't have the kind of artifical barriers you would have if every Government had a separate welfare system and they competed to push out the poor and to keep the benefits down.

Third, Mr. Chairman, medicaid really belongs in another box. That belongs in a box with medicare. We don't have a welfare mess. The welfare rolls are not growing. We have a medicaid mess, a health care policy mess, and what we really ought to do is rethink our health care programs. And President Ford had a much better proposal than any I have seen to do exactly that. It could go back. This whole business of New Federalism and sorting out functions, in my 100 years of working on it, is not so new. We have been working on these things for a long time, and further, the whole idea of a grassroots trust fund, I don't see any need for that. The Federal Government's got everything it can do to come even somewht closer to reducing its deficit. It's got to reduce the deficit, and I would leave that out. So it seems to me to be a simpler way of doing this.

I have to end on a quote that I always use. I always quote your man, Mencken, Mayor Schaefer, who said, "For every human problem there is a solution which is simple and wrong." [Laughter.] I apologize if mine is in that category.

[The prepared statement of Mr. Nathan follows:]

PREPARED STATEMENT OF RICHARD P. NATHAN

In 1981, the Reagan administration proposed and Congress enacted the largest peace-time redirection of federal budgetary policy since the New Deal. Domestic spending was sharply reduced; fifty-six categorical grants were combined into nine block grants, the intention of the block grants being to give state governments greater control over many federal programs. Further cuts and basic changes in the domestic programs of the federal government are proposed in 1982 for fiscal year 1983.

This redirection of spending, combined with efforts to shift the control of many programs from the federal government to the states, will have important repercussions for domestic government in the United States. Four types of effects are likely to be of great interest:

* effects on the finances of state and local governments and the nonprofit organizations that have been receiving federal funds;

* effects on the services these governments and organizations provide;

* effects on particular population groups and geographic areas and,

* effects on institutions and processes of state and local governments.

Information on these four types of effects will be important not only in evaluating the Reagan administration's domestic program but also in gaining a deeper understanding of the workings of the American federal system.

This statement describes a field evaluation study being conducted by a network of political scientists and economists on the effects of the Reagan policies on the policies, processes and operations of state and local governments. The first phase of the study is supported by a grant of $908,400 from the Ford Foundation. The planned research period will extend through fiscal year 1984, which ends September 30, 1984.

The researchers are studying changes in the budgets, service levels, and political and institutional arrangements of a representative sample of state governments and local governments in both urban and rural areas. Researchers in the field use a common reporting format; their efforts are coordinated by a central staff. The sample of fifty-four governments is structured to yield generalizations about how the Reagan program affects different types of jurisdictions, while at the same time covering a large enough proportion of the national population to permit analysts to draw major conclusions about the effects of the Reagan domestic program for the country as a whole.

U.S. DOMESTIC PROGRAMS

Researchers who study the effects of federal domestic programs must begin with a clear understanding of the nature of those programs. Less than 10 percent of the domestic activities of the federal government involve direct expenditures. The other 90 percent are conducted indirectly, through payments to individuals and grants to institutions. This larger portion of the federal domestic budget can be described in rough terms as three parts payments to individuals (primarily social security) and one part grants-in-aid to state and local governments and nonprofit institutions. The recipients, not the federal government, make decisions about the purchases of goods and services made with these funds.

The nature of grants-in-aid presents a special challenge for analysts studying their effects. A grant-in-aid consists of three things: (1) authorization and appropriation laws; (2) administrative regulations; and (3) the behavior of the people who carry out these laws and regulations. The third factor, which comprises the behavior of both federal officials and the people on the receiving end of grants, is often neglected but can be the most important of all.

FIELD NETWORK EVALUATION RESEARCH

In this complex and fluid policy setting, no existing, uniform data set can be used for the nation as a whole to answer questions about the services reduced as a result of the Reagan administration's domestic policy changes, and the groups affected by those changes.

The best way to find out about the effects of the domestic budget cuts and block grants is to go out and look. This is what researchers who will participate in the proposed project have been doing for the past decade. In 1972, the Ford Foundation provided a grant to The Brookings Institution for a study of the effects of the general revenue sharing program that had just been enacted. Since then, three other field evaluation studies have been conducted, both at Brookings and Princeton University, of the community development block grant (CDBG) program, the public service employment (PSE) component of the CETA program, and of all federal grants-in-aid received by eleven major cities in fiscal 1978.

These four studies used a field network evaluation method, as does the new study. This approach has the following elements:

* Field research associates study the effects of a federal program or programs in selected state and local jurisdictions. Some of the associates are political scientists, others are economists. All live in or near the jurisdictions they study; none is connected with the governments studied. They focus on how the federal program in question has affected each jurisdiction's finances; the level of services it provides; population groups in the jurisdiction; and the government's institutions and political processes. Although each associate works independently, they use a common analytical framework and submit program and financial data according to standard formats.

* A central staff coordinates the activities of the associates.

* Reports are published on the associates' findings. In the case of the studies on revenue sharing, CDBG, and PSE, a core group consisting of a central staff and some of the field associates prepared overview reports drawing on the findings of all the field associates. For the eleven federal aid case studies of major cities, each associate prepared his or her own report according to a common framework.

* Except for the case studies, the evaluation studies have been longitudinal, permitting analysts to study program effects over time. The case studies present findings for fiscal 1978.

* In the revenue sharing and PSE studies, a parallel econometric analysis was conducted that built on the experience gained in the field. Linking the two research approaches in this way allows them to complement and reinforce each other.

Field research of this type is needed to study the effects of the Reagan domestic program because the data available from other sources are not adequate. Federal budget data do not provide the needed information on the state and local programs and activities affected. Census data on state and local government expenditures provide only limited information on the response of states, localities, and nonprofit organizations to national policy changes. Likewise, budget documents and financial reports from state and local governments do not provide detailed information on the services and groups affected by national policy changes. Moreover, these state and local government documents do not present data in a comparable form.

Records and reports of particular state and local agencies provide a great deal of the needed detail, but they must be interpreted and augmented by analysts who are familiar with the local situation and can interview the officials involved in administering the programs being studied.

THE SAMPLE

The sample for this study is a structured, representative sample that will permit generalizations for different types and sizes of state and local governments facing varying economic and fiscal conditions. Fourteen states have been selected, and within them fourteen major cities, along with twenty-six smaller suburban and rural jurisdictions. The states and large cities, shown in the table on the next page, are in every region and vary economically and demographically. The cities include some that are fiscally distressed and others that are growing and relatively well off.

This sample is based on states so that researchers can take into account the ways in which state government responses to the Reagan program affect local governments within the state. In the case of the municipalities and townships in the sample, we will study all major federally

Sample States and Major Cities

States and Cities	Region	1980 Population (in thousands)
Arizona	Southwest	2,718
Phoenix*		790
California	West	23,669
Los Angeles*		2,967
Florida	Southeast	9,740
Orlando		127
Illinois	Midwest	11,321
Chicago*		2,970
Massachusetts	Northeast	5,737
Boston*		563
Mississippi	South	2,521
Jackson		202
Missouri	Midwest	4,917
St. Louis*		453
New Jersey	Northeast	7,364
Newark		329
New York	Northeast	17,557
Rochester*		242
Ohio	Midwest	10,797
Cleveland*		574
Oklahoma	Southwest	3,025
Tulsa*		361
South Dakota	Midwest	690
Sioux Falls		81
Texas	Southwest	14,228
Houston*		1,594
Washington	Northwest	4,130
Seattle		494

* A 1978 federal aid case study was conducted in this city.

aided services and activities in the area, including those provided by overlying state, county, and special district governments, and by nonprofit institutions.

ORGANIZATION

The central staff for this study consists of three senior-level professionals, plus research assistants and students at the Woodrow Wilson School, Princeton University. Richard P. Nathan, professor of public and international affairs and director of the Princeton Urban and Regional Research Center, is the project director, assisted by Robert F. Cook, economic analyst for the Center. John W. Ellwood, an expert on the federal budget currently serving as a fellow at the Woodrow Wilson School, is supervising the analysis of the 1982 and 1983 federal budgets. Philip M. Dearborn, an expert on municipal finance, and Clifford A. Goldman, formerly Treasurer of the State of New Jersey, are also serving as senior staff members for this study. Charles F. Adams, Jr., a field associate for Ohio, will conduct an econometric analysis along with Dr. Cook, using statistical and field data on a complementary basis to study the effects of the Reagan domestic program. As in previous projects, other field associates will be called upon for selected analysis and writing duties. David L. Aiken, director of publications at the Princeton Urban and Regional Research Center, will edit the papers and reports on this research. A list of the field research associates and study jurisdictions is available from the Center.

An initial report on this study will be issued in mid-1982 based on preliminary analyses from the field associates. A full report on the effects of the Reagan domestic program in federal fiscal year 1982 will be issued next year, along with special reports.

Four books on previous field network evaluation studies have been published by The Brookings Institution; other publications on the findings and methodology are also available. A list of books and papers on the findings and methodology of the overall research program is available from the Center.

THE PRINCETON URBAN AND REGIONAL RESEARCH CENTER
The Woodrow Wilson School
Princeton University
Princeton, New Jersey 08544

PRINCETON UNIVERSITY URBAN AND REGIONAL RESEARCH CENTER
PRELIMINARY: JOINT ECONOMIC COMMITTEE, FEBRUARY 19, 1982

TABLE 1: BUDGET AUTHORITY REDUCTIONS FOR FISCAL YEARS 1982 AND 1983 FOR SELECTED PROGRAMS AFFECTED BY OMNIBUS RECONCILIATION ACT OF 1981 (a)

Program	FY 1982 Change from FY 1982 CBO Current Policy Baseline Resulting from 1981 Reconciliation Act		FY 1983 Change from FY 1983 OMB Current Services Baseline Resulting from Reagan Budget	
	Dollars (millions)	Percentages	Dollars (millions)	Percentages
	ENTITLEMENTS (PAYMENTS TO INDIVIDUALS)			
Social Insurance Programs				
OASI (basic social security)	+86	+0.0	0	0.0
Disability insurance	+11	+0.0	0	0.0
Railroad retirement	+3	+0.1	+1,100	+20.0
Military retirement	-431	-2.8	-89	-0.5
Civil service retirement	-539	-1.8	-8	-0.0
Medicare	-187	-0.3	-2,910	-4.7
Unemployment compensation	-200	-0.8	+62	+0.3
Subtotal	-1,257	-0.4	-1,845	-0.6
Welfare Programs -- Direct Payments				
Student financial assistance	-550	-12.3	-1,775	-49.7
Student loan programs	-479	-15.5	-912	-26.8
Trade assistance benefits	-1,560	-85.3	-143	-80.3
Food stamps	-1,708	-13.9	(c)-2,294	(c)-18.1
Special milk	-95	-76.0	-29	-100.0
Child nutrition programs	-1,398	-34.0	-340	-10.7
Supplementary security income (d)	+150	+1.9	-286	-3.1
Veterans burial benefits (d)	-75	-30.9	0	0.0
Subtotal	-5,715	-16.8	-5,779	-17.9
Welfare Programs -- Grants to State and Localities				
Medicaid (d)	-1,172	-6.3	-1,536	-10.6
Assisted housing (sec. 8) (d)	-11,557	-40.4	-22,534	-130.2
Public housing operating asst. (d)	-260	-21.0	-152	-12.4
AFDC	-1,158	-17.6	-1,155	-17.5
Low-income energy	-372	-16.6	(b)-649	(b)-33.3
Subtotal (Grants)	-14,519	-25.4	-26,026	-62.6
Subtotal (all welfare)	-20,234	-22.2	-31,805	-43.0

<u>Fixed-cost Uncontrollables</u>				
Contributions to international organizations	-100	-18.1	0	0.0
Farm price supports	-0	-0.0	-0	-0.0
Payment to Postal Service	-879	-48.2	-308	-38.1
Subtotal	-979	-20.9	-308	-6.1
Subtotal: Entitlements & Other Uncontrollables	-22,470	-5.9	-33,958	-8.8
DIRECT GRANTS TO STATE & LOCAL GOVERNMENTS				
Wastewater treatment grants	-3,560	-99.9	+2,400	NA
Highway trust fund	0	0.0	-1,075	-12.1
State highway safety	-42	-100.0	0	0.0
UMTA grants	-1,298	-25.5	-599	-16.0
Air transportation grants	-189	-24.0	+450	NA
CDBG	-294	-7.4	-270	-7.2
UDAG	-175	-25.9	-34	-7.2
EDA grants	-358	-57.5	-198	-100.0
Impact aid	-391	-45.2	-186	-39.2
Elementary & Secondary Education Block Grant	-175	-22.9	-139	-24.3
ESEA Title I	-430	-10.9	-1,139	-37.0
CETA, except title VI	-4,448	-53.2	-1,400	-37.0
CETA, title VI	-1,129	-100.0	0	0.0
Social services block grant	-679	-21.9	-476	-19.4
Community services block grant	-196	-33.4	-291	-73.7
Primary care block grant	-68	-19.3	(b)-13	(b)-3.0
Maternal & child health services block grant	-122	-24.6	(b)-382	(b)-27.6
Alcohol, drug abuse, and mental health block grant	-200	-28.9	0	0.0
Preventive health and health services block grant	-33	-25.8	0	0.0
Refugee assistance	-69	-10.6	-171	-24.3
Capital loans to D.C.	-39	-20.1	0	0.0
Subtotal	-13,895	-31.6	-3,523	-11.4

DIRECT FEDERAL OPERATIONS

Defense Department pay comparability	-1,625	-23.6	-838	-17.0
Civilian pay comparability	-2,156	-64.5	-824	-52.1
Food for Peace (P.L. 480)	-132	-9.2	0	0.0
Export-Import Bank	-1,349	-22.6	-856	-24.1
Fossil energy R&D	-288	-38.5	-340	-76.1
Fossil energy construction	-464	-96.3	0	0.0
Energy supply R&D	-474	-19.9	-568	-23.3
Uranium supply & enrichment	-2	-0.6	-109	-100.0
Strategic petroleum reserve	-3,833	-93.6	+38	+18.6
Department of Energy -- Economic Regulation	-147	-76.6	-2	-6.9
Department of Interior -- absorption	-586	NA	NA	NA
Army Corps of Engineers -- construction	-178	-10.3	0	0.0
Agriculture credit insurance fund	0	0.0	0	0.0
Business loan and investment fund	-318	-46.8	-259	-64.3
Grants to Amtrak	-313	-29.9	-185	-23.6
Energy conservation	-158	-30.4	-254	-98.4
Youth Conservation Corps	-60	-100.0	0	0.0
Rehabilitation loan fund	-137	-100.0	0	0.0
Disaster loan fund	-180	-100.0	0	0.0
Conrail	-105	-18.8	0	0.0
Northeast corridor track improvement	-186	-48.2	-70	-37.8
Subtotal	-12,691	-40.4	-4,267	-23.9
GRAND TOTAL	-49,056	-10.1	-41,748	-9.6

Note: The two sets of reductions cannot be added since they are estimated from two different baselines. The CBO current policy baseline relies on different economic and programmatic assumptions than the OMB current services baseline.

(a) Adapted from John W. Ellwood and Associates, The Reagan Domestic Program (New Brunswick: Transaction Books, forthcoming).

(b) Includes further consolidation of categorical grants into block grant.

(c) Includes Nutrition assistance to Puerto Rico and territories.

(d) These programs are appropriated entitlements.

PRINCETON UNIVERSITY URBAN AND REGIONAL RESEARCH CENTER
PRELIMINARY: JOINT ECONOMIC COMMITTEE, FEBRUARY 19, 1982

TABLE 2: OUTLAY REDUCTIONS FOR FISCAL YEARS 1982 AND 1983 FOR SELECTED PROGRAMS AFFECTED BY OMNIBUS RECONCILIATION ACT OF 1981 (a)

Program	FY 1982 Change from FY 1982 CBO Current Policy Baseline Resulting from 1981 Reconciliation Act		FY 1983 Change from FY 1983 OMB Current Services Baseline Resulting from Reagan Budget	
	Dollars (millions)	Percentages	Dollars (millions)	Percentages
ENTITLEMENTS (PAYMENTS TO INDIVIDUALS)				
<u>Social Insurance Program</u>				
OASI (basic social security)	-2,031	-1.4	0	0.0
Disability insurance	-256	-1.3	0	0.0
Railroad retirement	-318	-5.3	-2,114	-36.9
Military retirement	-431	-2.8	-99	-0.6
Civil service retirement	-544	-2.7	-489	-2.3
Medicare	-1,384	-2.9	-2,471	-4.3
Unemployment compensation	-786	-4.0	-6	-0.0
Subtotal	-5,750	-2.1	-5,179	-1.7
<u>Welfare Programs -- Direct Payments</u>				
Student financial assistance	-54	-1.2	-116	-3.6
Student loan programs	-323	-7.9	-780	-23.4
Trade assistance benefits	-1,560	-85.3	-143	-80.3
Food Stamps (d)	-1,708	-13.9	(c)-2,258	(c)-17.9
Special milk	-103	-83.1	-25	-92.6
Child nutrition programs	-1,370	-34.0	-287	-9.6
Supplementary security income (d)	+150	+1.9	-286	-3.1
Veterans burial benefits (d)	-75	-30.9	0	0.0
Subtotal (direct payments)	-5,043	-14.9	-3,895	-12.3
<u>Welfare Programs -- Grants to State and Localities</u>				
Medicaid (d)	-944	-5.2	-1,987	-10.5
Assisted housing (sec. 8) (d)	-116	-1.7	-500	-6.4
Public housing operating asst. (d)	-135	12.6	-84	-7.0
AFDC	-1,158	-13.5	-1,155	-17.5
Low-income energy block grant	-372	-16.6	(b)-649	(b)-33.3
Subtotal (Grants)	-2,725	-7.4	-4,375	-12.0
Subtotal (all welfare)	-7,768	-11.0	-8,270	-12.1

<u>Fixed-cost Uncontrollables</u>

Contributions to international organizations	-73	-14.0	0	0.0
Farm price supports	-720	-20.0	0	0.0
Payment to Postal Service	-879	-40.2	-308	-38.1
Subtotal	-1,672	-28.1	-308	-9.7
Subtotal: Entitlements & Other Uncontollables	-15,190	-4.4	-13,757	-3.7

DIRECT GRANTS TO STATE & LOCAL GOVERNMENTS

Wastewater treatment grants	-75	-1.7	+464	+116.1
Highway trust fund	-500	-6.0	-406	-4.8
State & community highway safety	-117	-55.7	0	0.0
UMTA grants	-198	-4.8	-801	-20.2
Air transporation grants	-152	-22.6	+125	+50.2
CDBG	-30	-0.6	-5	-0.1
UDAG	-17	-2.3	-1	-0.2
EDA grants	-11	-2.0	-20	-7.6
Impact aid	-313	-37.4	-154	-31.2
Elementary & Secondary Education Block Grant	NA	NA	-52	-8.3
ESEA Title I	-38	-1.1	-409	-13.8
CETA, except title VI	-3,407	-40.9	-1,610	-42.5
CETA, title VI	-1,092	-97.7	0	0.0
Social services block grant	-679	-22.0	-476	-19.4
Community services block grant	-118	-20.7	-185	-55.1
Primary care block grant	-23	NA	(b)+102	(b)+33.9
Maternal & child health services block grant	-41	NA	(b)-296	(b)-22.4
Alcohol, drug abuse, and mental health block grant	-67	NA	0	0
Preventive health and health services block grant	-11	NA	0	0
Refugee assistance	-27	-4.0	-259	-29.0
Capital Loans to D.C.	-40	-21.6	0	0.0
Subtotal	-6,956	-16.6	-3,983	-11.9

DIRECT FEDERAL OPERATIONS

Defense Department pay comparability	-2,816	-41.1	-838	-17.0
Civilian pay comparability	-2,069	-63.8	-824	-52.1
Food for Peace (P.L. 480)	-128	-9.1	0	0.0
Export-Import Bank	-111	-4.9	-86	-4.3
Fossil energy R&D	-236	-31.8	-483	-70.4
Fossil energy construction	-194	-51.5	0	0.0
Energy supply R&D	-173	-7.4	-96	-4.6
Uranium supply & enrichment	-191	-76.4	-110	NA
Strategic petroleum reserve	-3,666	-93.6	+40	+15.3
Department of Energy -- Economic Regulation	-88	-48.6	0	0.0
Department of Interior -- absorption	-341	NA	NA	NA
Army Corps of Engineers -- construction	-135	-8.0	0	0.0
Agriculture credit insurance fund	-404	-47.6	0	0.0
Business loan and investment fund	-207	-31.0	-336	-72.1
Grants to Amtrak	-271	-29.1	-155	-20.3
Energy conservation	-51	-9.0	-217	-48.7
Youth Conservation Corps	-48	-100.0	0	0.0
Rehabilitation loan fund	-160	-100.0	0	0.0
Disaster loan fund	-107	-40.1	0	0.0
Conrail	-335	-72.8	0	0.0
Northeast corridor track improvement	-8	-2.5	-35	-9.9
Subtotal	-11,739	-42.7	-3,140	-19.3
GRAND TOTAL	-33,885	-8.1	-20,880	-5.0

Note: The two sets of reductions cannot be added since they are estimated from two different baselines. The CBO current policy baseline relies on different economic and programmatic assumptions than the OMB current services baseline.

(a) Adapted from John W. Ellwood and Associates, The Reagan Domestic Program (New Brunswick: Transaction Books, forthcoming).

(b) Includes further consolidation of categorical grants into block grant.

(c) Includes Nutrition assistance to Puerto Rico and territories.

(d) These programs are appropriated entitlements.

Representative REUSS. Thank you, Mr. Nathan, and thanks to the entire panel. I take the problem of the cities very seriously. Indeed, I don't think the witnesses are calamity howlers or false prophets of doom at all. I think your concern is justified.

It seems to me that certain truths are self-evident in our governmental system; that you need central financial responsibility for the welfare of our cities, for the simple reason that the only basis of taxation in accordance with ability to pay in a meaningful way lodges in the Federal Government. They are the people who can impose progressive income taxes and modestly progressive inheritance taxes. If the State or cities try to do it, people vote with their feet and go elsewhere.

If the State imposes too high an income tax, they move to Texas where there isn't one. If the death taxes get out of hand, the older and well-heeled folks move to Florida where there is substantially no death tax. The taxes which States and localities by and large have in their cornucopia of taxation are regressive taxes. You need them, but there are very definite limits on them because they mainly affect the poor and particularly the middle-income people, property taxes on the homeower and the sales tax on the consumer.

I now come to my point. Every once in a while in the history of our Nation a great climateric occurs—the *Dred-Scott* decision of the Supreme Court or the Hawley-Smoot tariff. We could each compose our own list.

The Reagan program resulted in a very substantial dissolving of the Federal income tax's progressive character, the reduction immediately of the capital gains rate from 28 to 20 percent, the rate on unearned income from 70 to 60 percent, the phasing out of the estate tax so that only a small fraction, 1 percent of American families, will shortly pay any State tax at all; the phasing down and almost out of the income tax on any large corporation where a comptroller possesses a sharp pencil. That list was coupled with the turning over to the States of a very substantial responsibility for feeding the hungry and keeping the rain and cold off of the old.

Do those decisions of the Reagan administration last year, concurring to its discredit by the Congress, portend to something in our Nation which, without hysteria, can and should be called a crisis? Mayor Schaefer.

Mayor SCHAEFER. Congressman, the more I come over here, the more I think the role of someone must be to call continually to your attention, to Paul's and Parren's, and to my good friend the mayor, who I have great respect for, but we don't see eye to eye, the human dimension. I listened to your very fine presentation and the thing that worries me so much—I agree with everything in the philosophical approach and I see statistics, but when you go over to Baltimore and you see the people, you just can't say you're a statistic and you've had it too good for too long. There are people that haven't had it too good for too long, the very old, the unemployed, the handicapped, the blind, that need that continual assistance. And what you have just said is absolutely true. I'm not coming over here bloodletting. I'm coming over here and trying to tell you what is happening in a city like Parren's.

If I were absolutely sure that in 18 months everything would be well, I could figure one way. There is no assurance of that. We just hope. But during that 18 months I can't pick up one Federal program that's been cut. The compounding effect is there.

And while it's nice to say you do the taxing, I don't think anyone hears me when I say there aren't that many taxpayers left in cities like ours. And you said it exactly right, because when you start telling a young person I'm going to raise your taxes by $4, you're going to move him to the county. And as sure as my name is Schaefer, the rest of the people are just not going to be able to handle this burden as far as taxes are concerned.

And that's a great theory. It's a great theory—let everybody down on my own level take care of everybody. If I were Anchorage, Alaska or if I were Houston, Tex. I could do this. I live in Baltimore, and what you said is true, absolutely true.

We're not coming here to beg, and the term, "to beg," you know, I used to worry about that when I'd go to the State legislature a couple of years ago. I used to worry because they always said here he comes again, his hat in his hand, and I used to go down and I started off by apologizing. I don't do that any more. I don't apologize. I don't come over here and apologize.

There's one thing I'm trying to say. Come on down and let me show you, and if you think these people can take care of themselves, you show me how to do it and I'll be glad to learn the history and the lessons of all you can give me. Come on over and tell me how to do it.

And what you said is true. But people aren't statistics. You know, people aren't statistics. They're human beings that we in the Federal Government and in the State government and the local government have an obligation to take care of. I'm not talking about those that don't want to work. I'm talking about those that do. I'm talking about the poor that need it. That's what I'm talking about. And you can glaze over it and forget it and go home and say my conscience is clear because statistically they're getting too much. It's not true.

Representative REUSS. Mayor Riley, do you think my characterization of the situation as a crisis situation is true?

Mayor RILEY. Exactly, Mr. Chairman. And I'm going to duck out in just a second, so I can catch my plane back home. The debate we have had here, and what is happening and what you, Mayor Schaefer, Mr. Bahl, and Mr. Nathan have addressed—what we have had in this country in the last 50 years is a period of great internal divisiveness and strife and cataclysmic things in terms of not only the mores but also the economic situation as we developed a good, moderate progressive system where opportunity was reasonably available.

I believe that the danger is, Mr. Chairman, that if we push down on the poor cities and on the poor and on the working poor, we begin to polarize our people greater and we begin to create greater divisions between the haves and the have nots. Moderation is a good policy in everything, from the way you live to the way governments govern, and my great concern is we are moving from a policy of moderation to one of extremism, which creates in our country the great dichotomy of haves and have nots. And that, Mr. Chairman, I think could erode not only the American dream but create for us politically more of the experiences that we have seen in England, for example, and other countries where you have in each election a great battle between poles. This is a great time to talk about the fact that the New Deal did not create a lot of problems. What it did was save capitalism and created a great country, the greatest country in the history of the world and created the greatest land of opportunity in the history of the world—a moderate, humane society.

What you said, Mr. Chairman is, you take away using the Trojan horse, those top brackets from those who have, and we spread it out to the poor and the working poor. Take that away and you lose that moderation, and you lose that humaneness, and that is the overriding problem that I think we all need to keep focusing on. [Applause.]

Representative REUSS. Let me turn to the third mayor here, a respected and honored——

Senator SARBANES. Mr. Chairman, could I just interrupt for a moment because I see Mayor Riley has to leave and catch a plane; but Mayor, I would just like to thank you for your extremely thoughtful testimony. I have not had the pleasure of meeting you before, although I have heard about your good work in Charleston, and we thank you very much for coming here.

There was reference earlier to having to have hope. I think one thing that gives us hope is having men like you as mayors of some of our great cities in the country. Thank you very much for your testimony.

Mayor RILEY. What pleases me is to see the three Members—the Senator and the Representatives we have here. I appreciate that very much.

Representative MITCHELL. Mr. Chairman, I think my unsolicited applause which probably broke some rule in the House is testimony to you and your committee.

Mayor RILEY. Thank you, sir.

THE ROLE OF THE FEDERAL GOVERNMENT

Representative REUSS. Just briefly, Mayor Hudnut, let me read to you the statements of two members of your party and see which one you would agree with.

Statement No. 1 is as follows:

> The issue whether people should go hungry or cold in the United States is solely a question of the best method by which hunger and cold shall be prevented. It is a question whether the American people on the one hand will maintain the spirit of charity and mutual self-help through voluntary giving and the response of local government as distinguished on the other hand from appropriations out of the federal Treasury for such purposes.

That's the first statement.

The second one is quite different. The second one goes as follows:

> Until this moment in our history as a nation, the central question has been whether we as a nation would accept the problem of malnourishment as a national responsibility. Speaking for this administration, I not only accept the responsibility; I claim the responsibility.

The first statement was by Herbert Hoover in 1932 and the second by President Nixon in 1969. Which one of the two——

Mayor HUDNUT. I agree more with the second statement than the first. I think that it's very important to emphasize the kind of human need that has been addressed by the other mayors. It cannot be denied, and I am deeply concerned about the negative impact on the poor and the disadvantaged who live in the cities, including Indianapolis, of further cuts. What I was trying to say was, that it seems to me in the interests of slowing down the train and reducing its momentum and reducing the escalation in the rate of growth and Government spending, we have got to hold the line all across the board. That's why I wanted to try to focus some of the conversation on the defense budget and on the entitlements program. I think the cities have had enough of the cuts. As I said, we took two-thirds of the first round, around $35 billion. I happen to live in a city where I don't have quite the same problem as Mayor Schaefer, because we have a unified government, and we have a consolidated approach between the city and county, and that means that our tax base is broader than his.

But irrespective of that, the eight-county area in which I live has the same kind of problems that he has elaborated on, wealth pursuing lower tax rates out through the periphery of the economic metropolitan area which is beyond the political jurisdiction that he and I represent. So consequently, there is a greater burden placed on those who live in central cities, and this is a serious problem, and I don't think that the New Federalism has really focused on it.

We agree with what Joe Riley says about the importance of trying to build a humane society and avoiding these kinds of absolutism or ideological rigidity that promote the extremes and the polarization that he was talking about. And I worry about that. Yesterday I spoke to 2,000 kids in one of our high schools; 75 percent of them were black, 25 percent were white. We are looking at 45 and 50 percent unemployment among the young blacks getting out of high school in our city and all across the country, at least up here in the Snow Belt, and I say what are we going to do about them? What are we going to do by way of manpower and womanpower training and development to help them. That's the crisis that we are facing, and I think the deeper crisis is the whole fiscal problem of the budget running away with us and nobody being able to control any of it. What I'm saying is, it's false to say the only controllable part of the budget is that 14 percent that goes to urban social programs and human services.

Representative REUSS. Thank you. Senator Sarbanes.

CITIES IN A VISE

Senator SARBANES. Mayor Hudnut, let me pursue that point with you for a moment. Would you agree with the logic that says that many of the central cities face an impossible situation; namely, the concentration of populations that need a range of services greater than in surrounding jurisdictions, while essentially they lack a tax base? No matter what your will is, you're caught almost in a vise, and there's a limit to what you can do. Mayor Schaefer is at the point now that the property tax in the city, despite, I think, a very efficiently run city government, is roughly twice the property tax in the surrounding areas. If he tries to raise the property tax, in order to provide the services in the face of cutbacks, you simply drive the remaining taxpayers out of the city, thereby worsening his revenue situation and moving him even farther down.

Do you perceive that as a logical problem for many, many cities?

Mayor HUDNUT. Yes, I think you're absolutely right. And I think one of the answers is in the consolidated approach we have and a number of other cities around the country have.

Senator SARBANES. My next question is, if you have that logical problem, where do you go for help? You said you must stop going to Washington.

Mayor HUDNUT. Well, there are a couple of things you can do. I tried to use the illustration of the option we have to increase the excise tax on our automobiles in our county, which would bring in the $4 million we have lost. That takes a lot of guts to do that. You just can't expect people always to vote to raise taxes to make up the shortfall that they lose elsewhere.

Senator SARBANES. Suppose they have the guts to do it, won't a lot of people affected by it then pick up and move?

Mayor HUDNUT. That's possible; yes.

Senator SARBANES. It would be counterproductive, even if you have the will.

Mayor HUDNUT. Well, you know you've got to be specific. You say a lot of people. Who knows? I live in a city of 750,000. But the other alternative—and I think this is something that we have to work on—is to try to promote economic development in these cities. And it's very hard to do with the competition with the Sun Belt.

Senator SARBANES. Who is going to promote it? Where is the wherewithal going to come from to promote it?

Mayor HUDNUT. Local government is going to do it and the local private sector initiative is going to do it. For example, up in Cleveland, George Voinovich, the mayor up there, tells me the Standard Oil of Ohio people have made a decision to come into the central core of his city with a $250 million project. And you can have projects like this. I worked for 18 months in Indianapolis to get a new skyscraper going downtown for a life insurance company rather than letting it go out beyond our political jurisdiction, way out into the suburbs.

It's hard to do, but it seems to me that is——

Senator SARBANES. Did you use any Federal money to do that?

Mayor HUDNUT. No. We gave them tax abatement at the local level provided by the State. And tax abatement, of course, can go beyond the point where it's useful, just like the IRB's can be abused. We do have serious problems, and I have to agree with you, we are in a vise, and not everybody can vote with their feet. A lot of people can't afford to leave. So even if it's the same kind of benefit structure in 50 States in the Union, there are going to be a lot of people who are going to stay in Indianapolis—in downtown Indianapolis—who are either the new poor or have been laid off, or the structurally unemployed, and we are going to have to deal with them, and we need the help that the Federal Government provides to do that. We want to do it all on our own. I think, however, that we have to all say that we simply cannot go on forever with the kind of spending on these programs all across the board that has characterized the growth of the Federal Government's budget in the last 15 years. And I'm not just talking about urban social programs. I'm talking about defense and entitlements.

PRUNING THE TREE

Senator SARBANES. Let's look at that for a minute, because I don't know that anyone quarrels with pruning the tree. The question is whether you're really chopping it down at its roots. Many programs are essential, aren't they, to providing a number of the poor who live in your city the means with which to meet their problems? I was struck by your comment about the weaning of America, of ceasing to look to the government for solutions to all the problems; take some of the responsibilities upon themselves. I don't quarrel with that as a philosophical idea, but how can you take such responsibilities, if you don't have a job?

Mayor HUDNUT. I think the Congress has been irresponsible in the last 15 years—and I say that as somebody who used to be over here—in that you have bitched these programs to an index that's taken them out of sight. And I was talking about reindexing them and saving some money and slowing down the rate of growth.

Senator SARBANES. Let's take that. You would index to the average wage increase; is that right?

Mayor HUDNUT. I think that's better than the CPI. There's a 3-point difference. That would save billions of dollars.

Senator SARBANES. Wait a second. Would you keep that over time?

Mayor HUDNUT. Yes. Why do you have to have two cost-of-living adjustments each year?

Senator SARBANES. Usually the average—no, I meant you'd stick with the average wage index as your standard; is that right?

Mayor HUDNUT. It's a possibility.

Senator SARBANES. Usually the average wage index runs ahead of CPI. It's a very unusual departure in recent years that that's not been the case. That, in fact, is how labor gets its reward for productivity. Now we face a productivity problem in the last few years. Let me ask the economist; isn't that correct?

Mr. NATHAN. The way I have heard it, Senator, is people say you should do it with wages or prices, whichever is lower. They vary. There have been periods in which wages have arisen faster. I think now prices are rising faster still.

Senator SARBANES. I know. But the assumption is if you tie it to the average wage index, it may not work.

Mayor HUDNUT. I threw that out as an illustration of what I considered to be the fundamental point, and that is somehow to slow it all down. Senator Hollings of your party has made a suggestion that I think makes a lot of sense, to forgo the July 1983 cost-of-living adjustment in both social security and governmental pensions and holding 1984 and 1985 adjustments to 3 points below the rise in the CPI, and that will save billions of dollars.

Senator SARBANES. Do you think most people on social security are receiving too much?

Mayor HUDNUT. No; I don't think they're receiving too much.

Senator SARBANES. Why then do you suggest holding them down instead of suggesting that we recoup the tax benefits that went, say, to the oil companies, or other similar aspects of the Tax Code? Why should we hold down social security recipients at the same time we're freeing up revenues in areas where there is not a strong case to be made either for investment in new plant or equipment or for meeting the pressing financial needs now bearing in on individuals and families?

Mayor HUDNUT. I think we should look there too. I think the Congress ought to look at all subsidies, whether for the oil industries or for agriculture, peanuts or cotton or sugar or what have you. You know, to say nothing of some of the subsidies Congress gives itself. You eliminate the franking privilege, we could save a quarter billion dollars. I don't disagree with what you say at all, Senator, in terms of going after other savings. I'm saying the problem of deficit is so big that we have to look everywhere. I mentioned entitlements and defense. I would also agree with what you say.

Senator SARBANES. What is the tax rate?

Mayor HUDNUT. It is about $12.50–$13 per $100 assessed valuation on the basis of a third rather than a half.

Senator SARBANES. And what is the tax rate in the surrounding area?

Mayor HUDNUT. It's less.

Senator SARBANES. By how much?

Mayor HUDNUT. I don't know how much. I'd say 20 or 25 percent less.

STATE AID

Senator SARBANES. And how much aid do you get from the State legislature?

Mayor HUDNUT. Not as much as we should. That's one of the problems.

Senator SARBANES. What percent of your members of the legislature come from Indianapolis?

Mayor HUDNUT. Well, let me give you an illustration. I don't know whether this is what you're driving at or what, but it's something that really concerns me. Indianapolis has 15 percent of the State's population. We give them 21 percent of their revenues on gasoline taxes, and we get 9 percent back in terms of the distribution of those moneys. That's why a lot of cities around the country are uptight about saying the new federalism is going to give the States a lot more responsibility, because it gets skewed away from the cities.

Senator SARBANES. You have a 15-percent membership of the legislature?

Mayor HUDNUT. Right.

Representative REUSS. Representative Mitchell.

Representative MITCHELL. Thank you, Mr. Chairman. Thank you very much. Mayor Schaefer, on Tuesday I was in a senior citizens high-rise on Pennsylvania Avenue, and I saw the people. I didn't see statistics; I saw people who were scared to death, senior citizens packed into a little community room saying, "They have already taken away my medical assistance. They're going to take your food stamps next week—next month." Panic. And I jointly urge you and many Members of Congress to come look at people. That's what the story is.

Mayor Hudnut, in your best wisdon, how many of the 43 programs that are proposed to be transferred to the State would the grand sovereign State of Indiana be able to absorb?

Mayor HUDNUT. Congressman, I'm not sure I can answer that because——

Representative MITCHELL. Can you give me a guesstimate? Do you think they would be able to absorb 80 pecent? 40 percent? 20 percent?

Mayor HUDNUT. That's hard to say, and I'm not for any of them going to the States until we can work out this mandatory pass-through mechanism, so cities don't get the short of the stick.

Representative MITCHELL. Given the present you don't know whether your State can absorb one of them or all of them; is that correct?

Mayor HUDNUT. That is correct.

FEDERAL RESPONSIBILITY

Representative MITCHELL. All right. You indicated that people of the Nation—this was the line of inquiry pursued by Senator Sarbanes—people would stop looking to the Government for solutions of problems and begin taking some of the responsibilities for those problems on themselves, sort of a bootstrap operation. I'd like you to be very specific, if you can be, with reference to your city, which I assume has some housing problems. What is it that the structurally unemployed in your city can do to provide housing? Or you mentioned black youth unemployment in your city. You said you are greatly troubled by that. What specifically would you tell the black youth in your city to do to create jobs?

Mayor HUDNUT. Well, I think you're going about it from the wrong end. I would go at it from the private sector point of view and try to galvanize the private sector when it comes to creating a pool of capital for housing rehabilitation or for the production of more jobs. I think that's the way we should go.

In our city, to give you an example, we have made an effort to stimulate that kind of private sector investment in working in tandem with the public sector, whether you're talking about the private industry council for jobs——

Representative MITCHELL. Again, you clarified it for me. You're not talking about the people. You're talking about solely the private sector as part of the people; is that correct?

Mayor HUDNUT. I'm talking about the private sector providing the kind of housing that you're speaking of, in addition to what we are providing through Government, and the same goes for jobs.

Representative MITCHELL. Mayor Schaefer, you have initiated quite properly and quite firmly the blue chip program where the private sector in response to your appeal in Baltimore agreed to take on a greater effort; is that correct?

Mayor SCHAEFER. Yes, sir.

Representative MITCHELL. And as a result of your almost anguished appeals the net results ultimately of that effort is now a pledge of half a million dollars. What were the sources of that?

Mayor SCHAEFER. Parren, let me—the same ones are giving who gave before.

Representative MITCHELL. Which are they?

Mayor SCHAEFER. Public utilities, major corporations, let me try to explain what I mean.

Representative MITCHELL. If I can, I want to get back. I just wanted to try to point out that here with all of your charisma and persuasiveness you have attempted to get the private sector to do some things, the net result being half a million in pledges coming mostly from public utilities. That's why I have difficulty understanding Mayor Hudnut's total reliance on the private sector.

Mayor HUDNUT. Sir, that is a misconstruction of what I said. Excuse me.

Representative MITCHELL. All right.

Mayor HUDNUT. I do not agree with that. There is a legitimate and proper role for government. I'm talking about a partnership between the public and the private sector. I have never said that government should be sloughing off everything on the private sector, and the private sector should be a surrogate for government. I think that the government has a responsibility. You're asking how we could stimulate more, given the fact we are hard pressed, by way of jobs or housing, and that's why I responded that I think the private sector has an obligation which it is not facing.

Representative MITCHELL. That's exactly my point. And up until the time that it does, somebody has to take the responsibility.

Mayor HUDNUT. Absolutely.

Representative MITCHELL. And if the State is not going to do it, it's going to be incumbent upon the Federal Government to do it. That's precisely the point I wanted to make.

Mayor HUDNUT. You're right.

Representative MITCHELL. All right. Mayor Hudnut.

Mayor HUDNUT. Yes, sir.

STATE ASSISTANCE

Representative MITCHELL. You, in your statement, indicate you felt a new era was dawning in terms of cooperation between cities and the States and the State legislative bodies. That does not, in my opinion, square with the statement you made before a committee of Congress in September, where you placed a great deal of emphasis on the fact, it was extremely difficult to get the kind of cooperation that was needed. Do you remember that testimony?

Mayor HUDNUT. Yes, sir.

Representative MITCHELL. What magical transformation has taken place——

Mayor HUDNUT. I don't know if it's any magical——

Representative MITCHELL [continuing]. To cause you to shift drastically your thinking?

Mayor HUDNUT. I wouldn't say it's drastic shift. If you read the statement I made today, I would say we are anxious, we are worried about it. I would hope there is the dawn of a new day. For example, Governor Snelling has the coalition of which he is the head; for example, the mayors have been asked for 75 years to work with the NGA on a couple of partnership projects. For example, my Governor is very concerned about what can be done to forge a better working cooperative relationship in our State. These are, I hope, straws in the wind. We have a very, very serious problem, which I do not need to minimize with regard to the domination of most State legislatures by rural and suburban interests that are insensitive to the problems of the city.

Representative MITCHELL. One more question, and I will relax a bit. By the way, I apologize for being late. I was down in Paul's neck of the woods down in Salisbury. The plane was delayed. They couldn't get the door open to find my baggage. But I wanted to be here.

MILITARY CUTS

Mayor Hudnut, you have indicated that you would be averse to some reduction in military spending. That spending is expected to grow from 23 percent in 1980 to 29 percent in 1983, 37 percent in 1982. Evidently, you have spent quite a bit of time thinking about the flowing of good money into the military which it can't absorb. Would you be able to give this committee a rough figure as to how you guesstimate as to where the rough percentage, where you think the military might be cut?

Mayor HUDNUT. I don't know as I have the expertise to do that. I am seizing on certain facts that have come to my attention with regard to the military. I think there's a lot of mismanagement. There's a lot of argument whether we need a B–1 bomber, an MX missile, or this or that. There's a lot of duplication, a lot of waste in the military.

Representative MITCHELL. Would you favor an approach like this? Where the military has $100 billion, I think, in unobligated, unexpended funds that we would hold up on further appropriations to that same tune over a period of years, until they spend the money sitting there?

Mayor HUDNUT. That makes sense. Or why don't you hold them to the same rate of increase or decrease you hold everything else to? Only hold it all the same way. Don't just pick on the cities.

Representative MITCHELL. I'm not accepting Fritz Hollings' position we freeze at last year's level, because that's not workable either, because we still have the inflation. In fact, obviously, if you freeze at last year's level and inflation stays at 8 percent or 9 percent, you've lost 9 percent of last year's income and that adversely affects the poor.

Thank you very much, Mr. Chairman, for letting me put my questions.

Representative REUSS. I would say to Mr. Bahl and Mr. Nathan, the fact that most of our questions have been directed to the three mayors in no way indicates a lack of interest in or attitude toward the remarkable and most helpful presentations they have made. I think Mr. Nathan himself was suggesting that that table that you spent all night preparing is not a very sexy subject for cross-examination. [Laughter.]

That's why perhaps we're going to ponder over these things afterward.

I've tried to be a little more cheerful about something. One of the good things that is happening in cities and here, for a wonder, the Congress was a help not a hindrance, is in the rehabilitation of existing buildings—historic structures, older structures. It just happens that Mayor Riley's Charleston has done some great things. In your city, Mayor Schaefer, just a few weeks ago I went up and looked at that thing of Jimmie Rouse's, the old arcade that is being—what do you call it? The Brown Arcade, which is a very exciting thing. And Mayor Hudnut, you've got a lot of similar things in Indianapolis. Is it the German-American Athletic Club, that old building that was fixed up?

Mayor HUDNUT. It's called the Athenaeum.

Representative REUSS. Anyway, I call it the German-American Club. But that's very exciting.

Mayor HUDNUT. They do drink Milwaukee beer there, sir.

CITY REVITALIZATION

Representative REUSS. Great. Do you, Mayor, share my feeling that while, of course, it's not a solvent for all your problems, that rehabilitating, rebuilding, revitalizing, remodeling, renaissance, is something that our cities, particularly the older ones like yours and mine, ought to go all out on?

Mayor SCHAEFER. Absolutely. We have gone through that theory of urban renewal years ago when everything was torn down and partially torn down. Now it's absolutely essential on restoration. I just want to offer a little cheery note, too. No, we couldn't have made the remarkable progress we made in the city of Baltimore without Federal help. There's no way we could have done the things we did, both in human services and improving the quality of life and improving our physical development of the city. No way. And that's why I invite people to come over and see a city that has utilized those human service programs in the proper way as well physical development.

Specifically, to answer your question, yes, rehabilitation is remarkable in these cities, and we're doing it—we're using one of the training programs. And I get off on these things. We are using the Federal funds to train young people to rehab houses, and we resold the houses to people at less than the cost they would have had had they gone out and had the rehabilitation by the private sector. So the answer is yes, sir.

Representative REUSS. Mayor Hudnut.

Mayor HUDNUT. I think you're absolutely right. I think the adaptive reuse of old buildings is mandatory. The old days of just bulldozing everything away and trying to create something new, I hope are gone. Every downtown represents, I hope, a healthy mix between historically preserved and rehabilitated buildings and new ones. I certainly feel that one of the things is crucially important if we are concerned about combating urban flight and urban blight is the Federal housing rehabilitation program. With a 312 here, maybe section 8 there, maybe a 202 here, maybe 235 there. We need it. We need it all, if we're going to do anything to conserve the housing stock in the central cities.

I am gratified in the new tax laws—I don't understand them fully by any manner or means, but I am gratified, however, that there seem to be substantial incentives there for historic preservation of downtown structures and the promotion of their adaptive reuse through the rehabilitation process.

INDEXATION

Representative REUSS. Mayor Hudnut, I won't take offense at all to your remarks about indexation. I think we have to look at indexation wherever found. For example, if we find that a given index relies too heavily on housing costs, let us say, then let's have our statisticians fix up that index, so that it more accurately represents. However, wouldn't you agree with me that the most outrageous preparation of an index occurred in what Congress again—may God have mercy on us—did last summer in indexing right up to the top the personal income tax? Sure, I'm not indexing, let us say, the first $30,000 of income of a person or family, so-called market basket, but to tell someone with an annual income of several million that he should continue to augment his wealth in terms of the vagaries of the Consumers Price Index, this is madness, isn't it? And shouldn't we repeal this outrageous blot on the 20th century which we have committed?

Mayor HUDNUT. Well, it's obvious you feel very strongly about that. [Laughter.]

Representative REUSS. Well, I hope you do, too.

Mayor HUDNUT. I do, sir. I don't have nearly the command of the subject that you have, and I don't happen to be in that tax bracket, so I'm not familiar with what these folks are doing, but you're right, and I think also I'm right when I say that we've got to somehow, whether it's reindexing, deindexing, or what, avoid the kind of escalation and the outlays that really the American economy can't maintain. That's the basic point that I'm trying to make, slowing it down all across the board. If everything in the grocery store is reduced by 12 percent, that's fine, but if it's only the bread and milk, you've got a problem. I'm appealing for fairness and equity in the application of the effort to restrain the growth in Government spending and not lay it all on the backs of the cities.

Representative REUSS. Senator Sarbanes.

Senator SARBANES. No questions, thank you, Mr. Chairman.

Representative REUSS. Congressman Mitchell.

Representative MITCHELL. No questions, Mr. Chairman, thank you.

Representative REUSS. Well, I could carry on for great length, but you've got to go back and run Baltimore and Indianapolis, and Mr. Bahl and Mr. Nathan have to repair to Syracuse and princeton to do the basic, thoughtful work which enables us pols to live from day to day.

We are most grateful to you gentleman for an extraordinarily helpful panel. We thank you for coming here, and we now stand in recess.

[Whereupon, at 12:01 p.m., the committee recessed, to reconvene at 10 a.m., Wednesday, February 24, 1982.]

THE 1982 ECONOMIC REPORT OF THE PRESIDENT

WEDNESDAY, FEBRUARY 24, 1982

CONGRESS OF THE UNITED STATES,
JOINT ECONOMIC COMMITTEE,
Washington, D.C.

The committee met, pursuant to recess, at 10 a.m., in room 318, Russell Senate Office Building, Hon. Henry S. Reuss (chairman of the committee) presiding.

Present: Representatives Reuss, Brown, and Heckler; and Senators Jepsen and Sarbanes.

Also present: James K. Galbraith, executive director; Louis C. Krauthoff II, assistant director; Mary E. Eccles, Paul B. Manchester, Deborah Matz, and Mark R. Policinski, professional staff members.

OPENING STATEMENT OF REPRESENTATIVE RUESS, CHAIRMAN

Representative REUSS. Good morning. The Joint Economic Committee will be in order for its continued hearings on the economy.

We are delighted to welcome this morning five distinguished Governors from around the Nation. Lest anyone conclude that because this morning's witnesses happen all to be Democrats that the hearing is designed with partisanship in mind, let me say that we invited and endeavored to get some six Republican Governors. All of them, however, having other engagements, had to decline. However, the Democrats, I believe, represent all that's fine in Jefferson, Grover Cleveland, F.D.R., and John F. Kennedy, so we are going to get a wide spectrum here and diverse opinions, of course, on federalism.

Let me say that we make no apologies for listing federalism on our agenda this year, as we have for many years in the past, and no doubt as we shall for many years in the future. While it is, of course, not as immediate a problem as disastrously high interest rates or unacceptable unemployment or business bankruptcies, nevertheless, it's going to continue to be the stuff of the Nation's economics and that we are going to talk about this morning.

Governors have been fighting a war on two fronts for a long time with Federal officials and local officials and frequently they get the same charge from both sides, that the State capitals haven't been distributing their fair share to help local governments and local residents. Is this charge true? If it is, how will the New Federalism bring about change? And if it's not true, will the fiscal stress so prevalent at the State level render States impotent to provide future assistance?

These are some of the questions we will be inquiring into.

We are delighted to have with us this morning Gov. Jerry Brown of California, Gov. Hugh Carey of New York, Gov. Edward King of Massachusetts, Gov. Richard Lamm of Colorado, and Gov. Scott Matheson of Utah.

Before hearing from our guests, Congressman Brown of Ohio has an opening statement.

Opening Statement of Representative Brown

Representative Brown. Thank you, Mr. Chairman. I'd like to join our chairman in welcoming you to this Joint Economic Committee hearing. I think that it's a fault of the recent elections rather than any partisanship of the chairman that we have all Democrats this morning, but since it's the second best choice we could make, I'm pleased to welcome all of you.

The President's state of the Union message proposed a plan that will provide more substance to his concept of New Federalism. While some particulars of that proposal no doubt may be subject to criticism, I believe it is a constructive step in sorting out responsibilities and providing for more efficient and meaningful intergovernmental relations. It creates new opportunities for the State and local governments and in the long run will provide an opportunity to bring governmental services closer to the people, making government more responsive to human concerns and thereby more efficient.

Too much attention has been placed on who gains and loses from the proposal. To begin with, most persons are ignoring the second part of the proposal which seeks to eliminate those gains and losses through a Federal trust fund financed by excise tax revenues. Besides, the President has expressed to several of us his willingness to compromise on details so as to make the necessary adjustments to make this change of improving federalism work. Beyond that, the opportunities that the New Federalism gives to States have not been adequately explored. I am anxious to hear your views on this topic, even on the possibility of what has been suggested as a third phase of the program which evens up some disparities between the States.

With the President's economic recovery plan largely in place and with significant efforts being made to return to the States the responsibilities that rightfully belong to them, this is an exciting yet challenging period for State and local governments. Recent history has established, according to the Advisory Commission on Intergovernmental Relations [ACIR], that Washington is unable to design programs that adequately meet the needs of all States and communities. The Federal median seems to serve no one. As ACIR said, "The Federal Government's influence has become more pervasive, more instrusive, more unmanageable, more ineffective, more costly, and above all, more unaccountable." As a member of the ACIR, I fully subscribe to that assessment. It is important because the assessment was made by a bipartisan group, which at that time was headed by former Mayor Beame of New York.

The President's proposal may give us a chance to cure the unique problems of each State by returning to us the resources with which to meet our needs and the responsibility which will provide a great opportunity for us to modify government in a new way.

Increasingly, the future of America will be determined at the factory and community level and in the various cities and States of the Nation rather than in Washington. The opportunity exists for State and local communities to determine their own economic destines by planning their own economic strategies to improve the welfare of their citizens. I understand that Massachusetts has been successful with one such strategy, and I am looking forward to Governor King's testimony regarding the Massachusetts success story which is somewhat unique.

A recent JEC study showed how tax reductions have helped both Massachusetts and New York, so Governors King and Carey will provide testimony that should be particularly interesting and which I welcome.

At a personal level, I hope that I can be a part of the renaissance in State and local governmental opportunities and perhaps even change the balance on this kind of panel since I'm looking currently at the governorship in Ohio. I very much look forward to your testimony, gentlemen.

Representative REUSS. Thank you, Governor. [Laughter.]

We are grateful that all the witnesses have, pursuant to our rule, given us their very compendious prepared statements which under the rule and without objection will be received in full, and we are going to hear from you, on advice of counsel, alphabetically.

Before I ask Governor Brown to start, I welcome my colleague, Congresswoman Heckler.

OPENING STATEMENT OF REPRESENTATIVE HECKLER

Representative HECKLER. I want to simply say I'm very proud to have Governor King here and I look forward to hearing your testimony, Governor, and delighted, of course, to see our former colleague, Governor Carey, as I welcomed many of his comments made in the Halls of Congress.

I want to say that I haven't had the opportunity to discuss the issues with all of the Governors on the panel, but our Governor from Massachusetts, I understand, was invited to discuss the Massachusetts experience, the effects of that experience, and how the State has survived. In fact, it's managing well, and growing even with a cutback in funds—and I think relates to the issues here. I understand the Governor was invited on that particular subject and I look forward to the testimony of all the Governors, especially Governor King.

Representative REUSS. Thank you.

Governor Brown, would you begin?

STATEMENT OF HON. EDMUND G. BROWN, JR., GOVERNOR, STATE OF CALIFORNIA

Governor BROWN. Thank you. I appreciate very much this opportunity to share with you California's deep concern about the short- and long-term impact of the President's economic program.

We meet at a moment when this Nation faces its greatest global economic opportunity since the end of the Second World War.

The key to our economic strength in the 1980's is the success of our high technology industries. These industries are now at a critical turning point.

An unrecognized flaw in the President's economic program is that it fails to meet this high technology challenge. Unless we create a national policy to spur transformation of our industrial base, we face a long season of economic decline.

For 30 years the United States has led the world in technological innovation. Our ability to make constant breakthroughs in product and process innovation has been directly responsible for our mounting productivity and prosperity.

We have suffered reverses to be sure in our auto, steel, color television, and textile industries, but our technological strength has seen these older sectors replaced by new information technologies as the driving force of our economic growth.

Explosive expansion in microelectronics, computers, biotechnology, telecommunications, robotics, and advanced energy systems has laid the basis for sustainable economic growth for the remainder of the century.

Such new technologies will not only be a major source of job growth in and of themselves, but also the key to retooling our older industries.

The most significant example today is in our merchant semiconductor industry.

Semiconductors, as you know, are the basic building blocks of the new information age. Companies such as Intel, National Semiconductor, Advanced Micro Devices, Motorola, and Texas Instruments continue to lead the world in supplying microprocessors for today's computers, smart tools, and satellite systems.

Two years ago, however, the Japanese made their first significant inroads into our merchant semiconductor market with their commercial introduction of the 16K memory chip containing 16,000 bits of information. I brought as an example a casing that encloses one of these 16,000 bit memory pieces and, as you can see, within there we have a computer that is a fraction of the size of your fingernail. It does the same work that a computer the size of that table did just 25 years ago.

By mobilizing large sums of money, the nation of Japan channeled cheap capital into its best companies so as to permit them to export memory chips below the U.S. cost of production.

This helped the Japanese move into a position where they today control 40 percent of the 16K RAM [Random Access Memory] market.

Our California firms report they are now forced to compete against this foreign onslaught by selling their 16K chips for little or no profit.

Following a similar process, the Japanese have captured a 70-percent market share of the next generation of memory chips, the 64K RAM. Here also our U.S. firms are selling their 64K chips at little or no profit in order to stay in the market.

Such targeted competition, together with the recent recession, has produced a severe decline in profits for the semiconductor industry—making it more difficult for them to invest in the long-term research and process development they need to regain their lead.

To be sure, the situation is not yet desperate. Overall, our semiconductor firms remain the world's most robust. They continue to invest heavily in the future.

But we have no reliable guarantee that this will continue indefinitely. Past laurels do not insure future dominance.

To remain globally competitive in the new information industries, we now need a vision as clear, a blueprint as strategic, and a plan as comprehensive as those of the Japanese, French, Germans, and other foreign competitors.

Viewed from this perspective, President Reagan's economic program is both a short- and long-term disaster. He has promised us short-term pain for long-term gain. In fact, his program offers only indefinite pain.

The most searing social indictment of the President's program is today's unemployment rate and the rising number of business bankruptcies.

Presidential representatives are wont to proclaim that the pain they have inflicted on millions of Americans will be justified by the new jobs the President's program will produce. "The best social program is a job" has been their refrain.

In fact, they have produced neither social programs nor jobs. Instead, the administration has abandoned a national bipartisan commitment to the needy which jeopardizes the national consensus upon which our economic recovery depends.

Three days age I co-chaired a National Governors Association meeting on technological innovation. Conference participants included the present Science Adviser to the President and his predecessor, representatives of private companies such as Apple Computer and Exxon, leaders of the National Science Foundation, the American Association of Engineering Societies, the National Council of Teachers of Mathematics, the American Vocational Association, and a variety of other professional organizations. Also present were Senator John Glenn, Representatives Heckler, George Brown, Tim Wirth, Ed Markey, and other political leaders with a deep concern for our technological and economic development.

I and the other half-dozen Governors were deeply impressed by the clear consensus expressed at this conference that this Nation faces a crisis in our research and educational policies.

Conference participants made it clear that we lag badly in promoting basic research in nondefense areas; in producing the engineers, computer scientists, and other top professionals we need; in providing technological literacy in math, science, and computer studies to our students; in equipping them with the job training they need for the new, high technology careers of the 1980's.

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In place of education and research budget cuts and supply-side incantations, the time has come to mobilize this Nation behind policies that will spur our technological development and the transformation of our economic base.

States likes California with its Silicon Valley and North Carolina with its Research Triangle offer impressive examples of technological growth. They demonstrate that with the proper policies our high technology industries can prosper. And I could mention States such as Massachusetts, New York, Maryland, and others that are following similar paths.

We need now to elevate these State models into a conscious national policy. Let me today suggest a four-point program designed to keep our economy healthy in the 1980's.

One, a "fair trade" policy: The President should immediately move to elevate semiconductor and high technology industries to the heart of our trade negotiations with the Japanese, entering into good-faith negotiations on outstanding questions. A top priority must be to insure that the Japanese market is as open to our goods as we are to theirs.

At the same time, the President should establish a commission to advise him on what actions he should take should such good-faith efforts fail. The commission should explore ideas such as limiting high technology imports to the previous year's level during a period of deep recession. The commission also should not rule out Presidential action under the national security provisions of section 232 of our Trade Code, should the situation become serious enough to warrant it.

Congress should also pass legislation designed to encourage and empower the President to focus on high technology concerns.

I would particularly like to draw the attention of this committee to the proposed High Technology Trade Act of 1982, introduced by Congressman Gibbons of Florida. This legislation provides a mandate for negotiating liberalization of international trade and investment in high technology products. I believe this act should be passed as soon as possible.

Two, increased research and development—under President Reagan's program, our commitment to nondefense research and development has actually been significantly reduced.

We must abandon this national folly.

Instead, the National Science Foundation and other public bodies committed to basic scientific research in engineering, computer sciences and related fields need budget increases beyond anything we have seen. We need to promote increased cooperation between industry and universities as we have done in California with creation of the MICRO project offering joint government-industry grants in microelectronics research; and we need to encourage cooperative research ventures among our high technology companies.

Three, capital formation for innovation—we need a far greater emphasis on targeting capital to promote high technology industrial innovation and expansion.

Untargeted and unfocused tax cuts are simply not adequate for today's global competition. Our American companies are forced to operate under rules and with a cost of capital far more onerous than their foreign counterparts.

In order to achieve a truly fair basis for international trade and competition, it is necessary to adjust our capital markets through the tax laws and direct public policy to encourage investing in and lending to those industries vital to our prosperity and national security.

We need to speed up the depreciation on short-lived equipment, instead of the present program which actually discriminates against high technology companies. And we need also a variety of other adjustments in the Tax Code, from changes in capital gains laws to employee stock ownership to encourage investment in such high technology and growth firms.

Our history shows us that Federal spending can promote economic development, from agriculture to housing to aerospace, once we make a national commitment to do so. The time has come to extend such successes to our high technology fields as well.

Four, human capital investment—perhaps the most senseless of the President's policies are his cuts in education and job training. I cannot understand, for example, how cuts in educational aid to college students of over 25 percent will help this country develop the skilled people it will need in the 1980's.

The time has long passed when we can accept second-rate technological literacy among our students.

We need a second post-Sputnick commitment to increased math, science, computer, and engineering study in our schools.

We must augment our traditional concerns for the "3–Rs" with a new emphasis on the "3–Cs"—computing, calculating, and communicating through technology.

This means our students must study more math, science, and computer learning. We must train more teachers. And we must make the use of computers and other interactive learning technologies commonplace in every classroom in America.

In this context, I would like to call your attention to a bill introduced by Representative Stark of California which will encourage companies to donate computers to elementary and high schools by giving them the same tax benefits that presently apply to university donations. There is perhaps no more exciting and significant movement in education today than the use of computers allowing interactive learning by young children. We should do whatever is necessary to encourage this development.

Our universities must dramatically increase the number of engineers and scientists they graduate. The American Electronics Association, for example, estimates we will graduate less than one-third the engineers needed by the electronics industry alone between now and 1985.

And we need a far greater commitment to job-based vocational training in the high technology careers of the 1980's. For example, my own State has established the California Worksite Education and Training Act, CWETA. This $25 million program has equipped thousands with the sophisticated skills necessary for the new technologies and jobs of the 1980's.

Business Week has estimated that 45 million existing jobs may eventually become obsolete due to the information revolution, most within the next 20 years. America must embark on an unprecedented job retraining effort to meet this challenge.

Twenty years ago, in a dramatic message to Congress, President John F. Kennedy summoned this Nation to greatness with these simple words:

> I believe that this Nation should commit itself to achieving the goal, before this decade is out, of landing a man on the Moon and returning him safely to Earth.
>
> No single project in this period will be more impressive to mankind, or more important for the long-range exploration of space; and none will be so difficult or expensive to accomplish . . .
>
> In a very real sense, it will not be one man going to the Moon; if we make this judgement affirmatively, it will be an entire Nation. For all of us must work to put him there.

These words are no less true today. We can maintain our technological leadership, meet our global challenge and in so doing create the tools to lift millions out of poverty.

But we will achieve this lofty goal only with a new partnership among business, labor, and government to insure that our information industries retain their leadership and America its economic vigor.

The jobs of millions of Americans depend upon it.

The health of our social fabric requires it.

The future of our Nation rests upon it.

Thank you.

[The material attached to Governor Brown's statement follows:]

Growth In An Era Of Limits

A New Economic Vision For A Changing World

State of California

Edmund G. Brown Jr.
Governor

December 3, 1981

State of California
GOVERNOR'S OFFICE
SACRAMENTO 95814

EDMUND G. BROWN JR.
GOVERNOR

December 15, 1981

GROWTH IN AN ERA OF LIMITS

A NEW ECONOMIC VISION FOR A CHANGING WORLD

America today is in search of a new economic vision.

We are the strongest power on earth. But so, too, were Spain, France and England in the final season of their greatness. Like them, we are a rich, aging minority in a world undergoing fundamental change. We must change as well--or face our own season of decline.

Our most fundamental challenge is to achieve economic growth in a new 'era of limits' on energy and resources.

America, unique among the nations, lives on an ethic of growth. Expansion has been critical to our economy. But as Frederick Jackson Turner noted in his classic, The Frontier in American History, growth has also been crucial to our social cohesion. It is difficult to imagine an America at peace with itself--or the world--if it does not produce rising incomes for all of its people.

But though grow we must, we cannot grow as we have. The cheap energy and resources powering our past expansion have become increasingly expensive and hazardous commodities in the late 20th century.

Expensive and scarce energy and resources are now producing as profound a turning point in our history as the nineteenth century shift from agriculture to industry, or our own twentieth century turn from domestic to international markets.

This new turning-point is often called the information revolution, in which information is replacing energy as the key to productivity growth. In this era, the building blocks of our economy are undergoing basic change:

First, information technologies have replaced heavy industry as our new growth sectors.

Second, using less energy and resources, not more, has become a key to increased productivity.

Third, labor shortages pose a major obstacle to growth for the first time in our history.

And fourth, expanding markets lie in the Third World, rather than in Europe.

These four historic shifts in the world economy require corresponding shifts in our economic policy. Too much of our current investment policy is geared to maintaining obsolete equipment, energy sources, labor practices, and international trading relationships.

To grow in the new era of limits we must accumulate capital and carefully direct it into modernizing our economy.

We need to understand that the information revolution is not a futuristic, "Star Wars" scenario of robots and Dick Tracy watches, but an economic reality which has already begun to transform the world in which we live.

During the past decade, for example, the information revolution has already become the driving force for economic growth in states like California, Massachusetts and New Hampshire, creating whole new industries employing tens of thousands of people.

Abroad, foreign governments like France, Austria and Japan have already decided to commit significant resources to develop new information technologies.

To continue to grow in an era of limits, we too must make a similar national decision.

We too must accumulate vast capital, and shift it from obsolete technologies to new ones capable of providing new growth and reviving old industries.

We will need, in short, a national investment strategy to develop new information technologies, efficient resource use, skilled labor, and third world markets.

Let me today suggest a four-point program for such a strategy, which I believe we badly need if we are to meet the challenge of the sophisticated economies of Asia and Europe and meet our own domestic need for meaningful work, economic prosperity and a sustainable environment.

1. INVESTMENT IN NEW TECHNOLOGIES

Our top economic imperative is to invest in the information technologies which have become our major growth sector--semiconductors and software, personal and business computers, bioscience and the new telecommunications, robotics and the new space industries of the 1990s.

The new industries built around them are already among our leading growth sectors--as in California where semiconductors and electronics have supplied 25% of all new manufacturing jobs over the past decade.

More importantly, the information technologies are the key to saving our existing industries--from textiles to aerospace, to autos--where computer-aided design and manufacture, robotics, and word processors are already in wide use.

And these technologies are also driving growth in the service sector--as anyone can testify who has dealt with an airlines clerk, done computerized research, or banked through an electronic teller.

The potential markets for these new technologies are enormous. The Congressional Office of Technology Assessment, for example, has cited figures indicating that the U.S. electronics market alone will grow 250% from 1978 to 1987. The personal computer market, according to industry analysts, is expected to grow 700% during the next 5 years--from 500,000 units sold in 1980 to 3.7 million units in 1985.

But information technologies will not ensure economic growth without a radical shift from excessive consumption to long term investment. We need to invest billions in research, improvement of new technologies and retooling our aging plant and infrastructure.

Lack of adequate investment threatens not only our older industries, but our newer, cutting-edge ones. Recently, for example, the Japanese have captured 70% market-share in the newest generation of memory chip, the 64K Ram. Semiconductor analysts have suggested that this one industry alone will need some $30 billion to remain competitive in the 1980s, up from $4-5 billion in the 1970s.

We must begin by targeting research and development for new technologies. The decade-long trend which has seen us lag beyond other nations in research growth must be turned around.

The times demand joint efforts between industry and government, and substantially increased government spending for basic research through the National Science Foundation, the National Institute for Health, the Environmental Protection Agency, the National Institute of Occupational Safety and Health, and the National Aeronautics and Space Administration.

This year we created a state-financed project, named MICRO, at the University of California to do basic research on microelectronic and computer sciences.

The research projects will be jointly financed by the government and private industry on a matching dollar basis.

Even more important than research and development, however, is capital formation for modernization. We can no longer see our best firms unable to expand or modernize because they lack access to capital at a cost equal to their international competitors.

Whatever fiscal, monetary, and tax incentives we adopt, we must ensure that they are targeted to spurring investment in productivity. Neither across-the-board reductions in depreciation schedules, nor indiscriminate government bailouts to ailing industries, are appropriate.

Our tax code has to be geared to encouraging innovative investment and discouraging consumption. Recently in California, for example, we took such a step. We eliminated completely the capital gains tax for businesses with less than 500 employees, the traditional source of technological innovation.

We made up the revenue loss by increasing the capital gains tax on antiques, paintings, gold, silver and other collectibles.

This is a concept that some call targeting. In the future we are going to do more of that. It is by directing or targeting our incentives to new growth-producing technologies that we will find a new economic path for the '80s. Neither across-the-board reduction in depreciation schedules nor government bailouts are adequate to insure a steady flow of capital to modernization.

A similar targeting principle should be extended to direct government help. When we decide to extend a loan or subsidy, for example, we must ensure that it will go to increasing the recipient's competitivness and productivity.

This nation is likely to hear increasing calls for a Reconstruction Finance Corporation, or the National Pension Fund bank proposed by the AFL-CIO, for example, should present "supply side" policies fail. We must ensure, however, that any funds allocated by such institutions go toward new technologies, new equipment, new energy sources, and new training--rather than to simply propping up companies that can no longer compete.

Pension funds can be a particularly important source of new investment capital. New policies are needed to give them greater flexibility in investment, and we have already proposed such measures here in California.

And pension fund loans can also be buttressed by government guarantees, which would give government far greater leverage for its capital, pension funds added security, and new technologies a major source of additional capital.

It is particularly important that special attention be given to fostering the entrepreneurial, innovative spirit that flourishes most in our smaller firms. We need tax cuts, incentive stock options, and loans tailored to innovative small businesses, rather than present policies primarily benefiting our largest corporations.

2. INVESTMENT IN RESOURCE EFFICIENCY THROUGH STEWARDSHIP OF OUR ENVIRONMENT

As energy and resources costs continue to climb we must develop cogeneration, photovoltaic, wind, and other renewable technologies that generate electricity safely and at a reasonable cost.

We need research for new, clean transportation fuels that can be developed out of agricultural wastes, biomass, and coal. Tremendous possibilities exist for methanol development if we just first make the commitment.

And more immediately, we need new incentives to commercialize existing least-cost energy strategies. The California Public Utilities Commission has already ordered our utilities to offer conservation and solar loans because it has found that giving people a low or a zero-interest loan for conservation retrofit and solar devices is actually more cost effective than centralized power plants.

Finally, we need to pay more attention to restoring and protecting our fish, our forests, our soil, and our water. This is the true foundation of our national wealth.

You may have read recently about the severe danger of soil erosion. It is not a topic that we hear about every day. Nevertheless, the food that we eat and which also provides so many export dollars derives from the soil and the water.

These are resources which must be protected and wisely managed. Yet, today more soil is shipped down the Mississippi River than corn, and it won't be too many years before that top soil is gone unless we change our ways.

To create one-inch of topsoil takes at least 1000 years. In ancient times, Mesopotamia was every bit as proud as our own middle west. Today the soil of that area is long gone with only barren desert blowing in the wind because of inadequate understanding and the mismanagement of salt buildup, mineralization and erosion.

We look at North Africa and can hardly believe it once was covered with rich forests. But mighty Rome needed wood for aqueducts, ships of war and maybe even for hot tubs.

God help us if we fall into the same trap when we have the capacity to increase the productivity of our own timberland by 50 percent. In California, we have already embarked upon a major program of reforestation through funds derived from geothermal, oil and gas revenues. Our philosophy is to tax our nonrenewable resources, the depletable resources, and redirect the funding into the renewable resources.

With respect to fisheries, we face more than a 50 percent decline from historic levels. We can reverse this but only by clearing thousands of miles of streams throughout our state. And that is precisely what we are now doing through our California Conservation Corps. As for water, we intend to recycle at least 400,000 acre feet and even more if our desalting plants perform as well as expected.

As we come to understand our staggering health costs from toxics and pesticides, moreover, we need a national priority on toxics clean-up. Recent California legislation creating a Superfund to clean up existing dumps, enacting stronger penalties for violations, and offering workers a toxics "right to know", point the way to the national policy we need.

Environment and growth are not opposed--they are inextricably linked. Wise, careful, caring use of our natural resources produces the wealth that is at the foundation of our civilization.

3. INVESTMENT IN HUMAN CAPITAL AND A NEW WORKFORCE

The third great shift we are experiencing is the increase in the shortage of skilled workers and this demands entirely new policies.

The baby boom of the fifties is moving into middle age. Americans between the ages of 16-24 will decline in the 80s, not surge by 40 percent as in the last decade.

The new growth industries are creating highly sophisticated jobs, demanding more trained workers than are currently available. Skilled jobs are going begging side by side with rising unemployment.

And that is the paradox: we have a shortage of nurses, a shortage of electronics people, computer specialists, engineers and we have to do something about it.

Automation will compound the problem by displacing 45 million existing jobs in the next two decades. Growth in the 80s therefore, demands a major investment in education and job retraining going far beyond anything we have done before.

Our elementary and high schools need to return to a new emphasis on fundamental communication, calculating, and scientific skills. We have to upgrade our teaching and provide more sophisticated equipment such as personal computers which can allow students to take a more active role in their education.

Our universities need a Sputnik-like push to turn out more scientists and engineers. Already, Japan, with half our population, is turning out 2000 more electrical engineers every year than we are.

The gap is growing. If we do not shift our priorities, it is only a matter of time before what happened in autos, TVs, calculators, and cameras is repeated in the electronics field.

Then there will be very few industries left in which America leads. Such an outcome is totally unnecessary if we make the kind of shift that I am suggesting today.

Vocational education and job retraining programs also have to be upgraded and retooled. We need employment-based job training and retraining.

What we need to recognize is that wealth derives from people--from human intelligence--and that we have to nurture that intelligence through education, research and manpower training in the private sector and in the public sector.

We have a model on how to do that. It's called the California Worksite and Educational Training Act. It is a $25 million effort that we started three years ago. It has had a remarkable success by targeting job training at the lower end of the scale, but including a career ladder for those who participate. Several thousand people and dozens of industries have worked very well with the community colleges to bring this about, particularly in electronics and nursing.

Finally, we need a training program targeted to areas of special need, from youth to minorities to welfare clients to those who are displaced by plant closings.

Beyond training, we also need to invest in strategies designed to involve working people in their own production, and in the quality of their work. The quality circle is an idea which was developed in America, transferred to Japan, and now brought home again. We have at the California Department of Motor Vehicles an experiment

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in quality circles where workers meet on a regular basis to discuss their work and share insights from the bottom up to improve productivity and their working lives.

In the face of fierce international competition, we have to work better, with greater insight and caring, to secure our economic prosperity.

4. INVESTMENT IN NEW MARKETS

Our economy growth in the post-World War II era has depended on new markets created in Europe and Japan, made possible in part through the Marshall Plan.

We've seen the Third World primarily as a source for cheap raw materials during the same period.

Now, Japan and Europe are our more vigorous competitors in more slowly growing domestic and international markets.

And the developing world, which bought 35% of all U.S. exports in 1979, is no longer merely a source of cheap materials.

To develop in the 80s, we can no longer look just to the developed countries of Europe and Japan. We have to turn our attention to the Third World, and help foster an economic framework there, so that the developing nations can become partners in global economic prosperity.

The key is expanding the buying capacity in the Third World. Many of the markets, particularly in steel and autos, in the developed world are simply stagnant.

Unless we can transfer technology to the countries of the Third World and help stimulate their buying power, we are going to find that our present period of economic stagnation will continue for the rest of this century.

We may need to create something like a Marshall Plan for the Third World which would involve a cooperative undertaking among the rich nations.

The goal of this plan would be to see these nations develop and enter the post-industrial marketplace, and to ensure global stability. In the 1980s, "gunboat diplomacy" will have to be replaced by "machine-tool" and "computer" diplomacy.

There is no more appropriate place for us to begin such a policy than with Mexico. A modern, developed Mexico on our southern border is in our most direct self-interest, as well as theirs.

RENEWING OUR INFRASTRUCTURE

As we undertake these four historic shifts to new technologies, resources, labor and international markets, we must not lose sight of another fundamental economic need: renewing our infrastructure of roads, bridges, highways and ports.

The explosive growth and development of the United States and other advanced nations in the last century was made possible only through a combination of private and public investment.

Waterways, canals, ports, and roads first opened up the country. Then came the railroads, followed by super-highways and, finally, the network of airports.

Now, following many years of neglect, we face a financial crisis of alarming proportions because of aging facilities and the hugh expenditures needed for replacement and expansion of our public structures.

A study this year by the National Council of State Planning Agencies asserts that:

--the nation's 42,000 mile interstate highway system is deteriorating at a rate requiring repair of 2000 miles of road per year. Over 8000 miles of the system are substandard, along with 13 percent of the bridges. Estimated cost: $700 billion.

--bridge rehabilitation and construction will require $33 billion.

--to maintain and renew city water systems will require between $75 and $100 billion in new investment.

--more than $25 billion will be needed for water pollution control and treatment facilities.

--tens of billions of dollars will be needed to expand and upgrade our ports to meet the needs of a doubling of foreign trade by the year 2000.

--upgrading the nation's rail systems will require many more tens of billions of dollars.

The total public investment this nation now requires staggers the mind. The Urban Institute estimates that maintenance alone--just keeping existing public infrastructure in repair--will cost over $660 billion in the next 15 years.

We cannot maintain new growth in the 1980s, without repairing the older structures that sustain it.

CONCLUSION: TOWARDS A NEW NATIONAL CONSENSUS

What I am really addressing is the development of a new national consensus--a shared vision of what America is and what it can become.

To grow in this era of limits, we must put aside facile economic nostrums. Neither conservative calls for less spending nor liberal calls for more spending really address our central economic dilemma, insuring that our spending, whatever it is, is directed toward modernizing our economy.

What is needed is basic agreement among leaders, business and labor, university and government, representatives of different regions and ethnic groups on a new strategy.

This will demand a political shift as profound as any we have ever encountered. For years our nation has thrived despite adversary relationships between managers, and labor, between different regions of the country, and more recently, between environmentalists and developers.

Such a division we can no longer afford. Our top political priority in this decade must be to foster a new spirit of cooperation in which we come to see that the benefit of each depends on protecting the public trust for all.

--Every racial and ethnic group will need to support job-training programs for all, rather than competing for jobs among each other;

--Corporate managers will need to place a new emphasis on risk-taking and long-term development, rather than focusing on short-term profits and immediate gain;

--Government leaders will need to promote greater fiscal discipline, and greater cost-effectiveness in programs and regulation;

--Workers will need to take an increased interest in how their companies are run and workplaces are organized.

Creating this new spirit of cooperation and national focus will not be easy. It will be as challenging as anything we have seen in our history in time of peace or war.

But, we have no choice. We have to proceed and proceed we must--confident in the knowledge that our best days are yet to come.

Representative REUSS. Thank you, Governor Brown.
Governor Carey.

STATEMENT OF HON. HUGH L. CAREY, GOVERNOR, STATE OF NEW YORK

Govenor CAREY. Thank you, Mr. Chairman. Mr. Chairman and members of the committee, I'm pleased at this opportunity to be with you this morning and be here during the time of deliberation of the National Governors Association. My testimony will center on the economy first and then some reference to the federalism concept.

I put it in this order because it seems that during the deliberation of the last several weeks and the association meetings these past few days concentration has been on federalism almost to the exclusion of discussion of the economy. I think that might be, giving a tested analogy, something like a football team being behind 21 to 0 at the end of the first half and going to the locker room and being asked how many are going to the junior prom. I think this time the score before us is the economy.

When I testified last year before the House Ways and Means and Budget Committees, I warned against adopting the tax measures and spending cuts then being advertised as the cure-all for the Nation's problems.

It is now clear that the supply-side vision that guided the administration was deeply flawed.

Business confidence has been eroded by soaring interest rates and a plunging stock market, and the only thing that has trickled down to the poor in the past year is surplus cheese.

We are now being reassured, however, that if we stick to this course it will produce favorable results; that it would be foolish to change course in midstream.

Yet it is easier, I think, to change our Nation's course in midstream than to have to salvage the sunken wreck of our economy, refloat it, refit it, and then try to steer it in the right direction.

The keystone of the President's strategy has been the Economic Recovery Tax Act of 1981.

Changes in the structure of Federal taxation were needed. Our tax system does discourage productive investment and savings, and it does encourage diversion of capital into unproductive tax shelters.

But some of the remedies that the President proposed, and the Congress adopted, have proved to be mistakes.

A first step in restoring fiscal stability and a sound economy must be to correct those mistakes.

The place to begin is with modification of the income tax cuts enacted last year, both to reduce revenue losses and to distribute more equitably the benefits of tax reduction.

I suggest we must roll back the promised cut in rates in July 1982 from 10 percent to 5 percent, restoring $20 billion to Federal revenues in fiscal year 1983, and drop the third tax cut from the legislation at least until economic and fiscal conditions justify it.

We must eliminate the provision for automatic indexing of the tax structure that takes effect in 1985, and stretch the tax brackets for households earning less than $40,000 a year.

Congress must act immediately to correct the most glaring inequities of the business tax cuts enacted last year.

Most significant of these are the new "net leasing" provisions.

The wholesale transfer of credits and depreciation allowances by highly profitable companies is clearly not an effective incentive and is a severe drain on revenues.

Even the Wall Street Journal has recognized that last year's leasing provisions were a mistake. In a recent editorial, the Journal described the new law as "a dud." The Journal is right.

In addition to these changes in the Tax Act, Congress should consider other tax measures that could help close the budget gap, without hurting low-income families, or discouraging savings and investment.

For example, capping the deduction allowed for consumer interest charges on all purchases except automobiles would increase Federal revenues by $4 to $5 billion in fiscal 1983.

In 1979 only 17 percent of all taxpayers took this deduction. A cap would probably affect less than 10 percent.

The changes I have suggested will significantly reduce the projected deficit for fiscal 1983, and for the next few years.

But just as important in the long run will be the major changes in the Federal Tax Code that are needed to insure a more equitable and rational taxing system.

Congress should begin by taking a second look at 15–10–5–3.

While major reforms in depreciation were clearly needed, and while the Congress is to be commended for having addressed this issue forcefully last year, it now seems clear that 15–10–5–3 was not the most appropriate way to resolve the problem.

In the years ahead, Congress should examine alternative approaches to depreciation, particularly the first-year capital cost recovery system proposed by Prof. Dale Jorgenson of Harvard.

Depreciation reform should be combined with reform of the investment tax credit program.

The existing credit, which in combination with accelerated depreciation is often excessively generous, should be replaced with special tax credits.

These credits should be targeted to stimulate research and development, encourage employment of the disadvantaged, promote construction of low-income housing, and stimulate investment in severely depressed areas.

In the long run, we should also examine other major changes in our tax system, including integration of corporate and personal income taxes, and increased exemption of interest and dividend income from taxation.

More modest tax reductions will allow us to use Federal resources for desperately needed investments in human resources and our capital plant, and to redesign Federal priorities without blindly and indiscriminately cutting Federal programs.

Here, of course, we come to perhaps the most dangerous and damaging part of the administration's economic plan: the cutbacks in investments in education and job training, as has been stressed by Governor Brown, and his education system in California is somewhat similar to ours.

Traditionally, investments in human capital have been as important as investments in physical capital in determining our real rate of growth.

With the bewildering rate of technological progress and increasing imports of manufactured goods, education and training will be even more important during the next decade.

Yet investments in human resources are being sharply reduced.

The proposed 23-percent reduction in employment and training funds for fiscal year 1983 will probably cost New York in excess of $100 million.

It will severely affect our ability to train low-income workers to meet the demands of today's job market, and to retrain those left jobless by present business conditions.

The proposed 21-percent cut in vocational education programs will have a similar effect.

Cutbacks in student aid programs, if sustained, will aggravate the shortage of skilled workers some industries are experiencing—especially in fields like engineering where educational costs are high.

Private schools, on which we in New York rely for most of our engineering talent, will be especially hurt.

For the administration to argue that "the best contribution the Federal Government can make to the undertrained and unemployed is to encourage the steady expansion of the private economy" is to deny both the evidence of history and social reality.

The public sector must play a role in economic recovery that is based upon a reasoned sharing of fiscal and administrative responsibility among Federal, State, and local governments.

It is, I believe, an economic fact of life that the nation can neither grow nor address the basic problems of poverty and low productivity without a national strategy for investment in human resources.

This strategy must attack the deeply rooted, persistent unemployment still widespread in this country, integrating into one coherent structure all of the diverse and fragmented programs that the Federal Government now funds.

An integrated network of programs should be administered at the community level by local or regional agencies, operating under State supervision and in accord with comprehensive State plans.

Industry should be actively involved in both the planning and delivery of on-the-job training and other services designed to help people obtain private sector jobs.

In order to provide secure and predictable funding, Congress should authorize funding of this new system on a long-term basis, and the level of funding available for employment and training services should be increased.

Experts in the field of employment and training have estimated that a system such as I have briefly outlined here could be established at a cost of about $20 billion.

This would not be entirely new spending—the new system would replace about 15 billion dollars' worth of categorical programs.

Just as important as this investment in human resources is our commitment to those in need, to creating opportunities for those who have never had any.

Existing programs aimed at these objectives need careful evaluation and revision.

Unfortunately, the administration's proposals are more a matter of semantics than economics.

The "truly needy," for instance, will decline in numbers not because the private sector is providing them with jobs, nor because Federal programs are working, but because changes in eligibility requirements will deny benefits to the very people that Congress intended to help when it created the programs.

In New York, we can already measure the impact of last year's cuts and anticipate what further cuts will do.

Women on welfare and even some of the working poor are expressing increased concern about their ability to even feed their families.

Recently, in cooperation with representatives of the business community and the voluntary sector, I established a Nutrition Watch Committee to monitor the impact of cuts in programs such as AFDC, food stamps, and school lunches.

The progress we have made toward eradicating malnutrition is being threatened.

Similarly, the enormous progress we have made toward creating a humane system for the care of the mentally disabled will be threatened by proposed cuts in Federal funding of "optional" medicaid services.

These may be optional in a legal sense, but few would argue that they are therefore expendable.

Let me say something that's happened on this point. In a discussion with a doctor who is head of our kidney institute in New York who was told by the Federal people who administered the program that they were going to cut the maintenance and hospitalization cost of those needing dialysis and needing kidney transplants—cut it to a level of 50 percent below the present costs—well, the doctors in charge said to the bureaucratic persons that they could not make that decision as to who would live and who would die, that had to be made by the Federal Government, and the Federal Government refused to do so. So it seems to me, Mr. Chairman, when you get to the human experience involved in some of these cuts, the very people recommending them are retreating from them and asking doctors to make decisions on who will live and who will die based upon inadequate funding. I hope we won't come to that point in this country.

Now criticism of these policies is now being raised by both Republicans and Democrats, and yet we must do more than quibble over particular cuts.

We must design a comprehensive program to provide the poor the opportunity to share in our economic progress.

Our program must include two components: Economic development resources and incentives for the revitalization of chronically depressed areas where large numbers of poor people live; and direct assistance to individuals who need help improving their positions in the job market, regardless of where they live.

Some of the initiatives I have already identified—tax credits for investment in depressed communities and for hiring the poor, and an increased Federal commitment to employment and training—would support this dual strategy.

Other policy initiatives will be needed as well.

The Congress could begin this process by restoring the incentives for work that were so mindlessly removed from the AFDC program earlier this year.

Further, we could begin using the resources of the welfare system more effectively to support the transition to regular employment.

For example, in New York we have established a new program called the temporary employment assistance program under which home relief grant funds from employable recipients can be used to finance private sector on-the-job training. It's working.

We are now prohibited by Federal law from doing the same for AFDC recipients. Here's a case of the Federal Government putting itself in the way of something that we have proven will work. The law should be changed.

If we are to stabilize Federal fiscal policy, we must complement a sound tax program with prudent controls on spending.

Domestic spending can be reduced prudently and humanely.

There is, for example, no valid reason to continue tobacco subsidies and various crop deficiency payments.

The synthetic fuels program has failed to demonstrate that it can significantly and efficiently reduce our dependence on foreign oil. It is simply a massive subsidy to some of the Nation's richest corporations.

The overall direction is clear. It should not be the job of the Federal Government to subsidize the incomes of individuals who don't need help, or of private companies that should be left to either succeed or fail on their own.

We must also curtail the massive planned increases in defense spending.

I am committed to a strong national defense but I do not believe the President's program will achieve that goal. The President seems to be convinced that in the area of defense, bigger is always better.

He thus fails to recognize that a sound defense strategy cannot emerge from an inability to distinguish between muscle and fat, and that the total Federal budget cannot be controlled as long as the Pentagon's budget is out of control.

In fact, the proposed rearmament program mocks any concern for reducing the Federal deficit, curbing inflation, and restoring our economy.

It is simply a massive shift of resources from domestic programs to the military that will threaten the growth and redevelopment of our civilian economy.

For the past decade it has been increasingly clear that we needed a thorough reexamination of State and Federal relations.

Growing regional disparities, shifting patterns of population and investment, mounting decay of our rail systems, roads, bridges, and harbors, all called for a realinement of resources and responsibilities. But the President's program meets none of these objectives.

Weakening the constructive role of the Central Government while aggravating the economic differences among regions, his proposals constitute a "new feudalism," not a "New Federalism."

Of course, last year, in a widely publicized press interview, the President stated that he was opposed to any redistribution of resources among regions, and to any "sorting out" of fiscal and administrative functions among different levels of government.

This view runs counter to the past 50 years of U.S. history, counter to the almost unanimous views of everyone that has studied the issue—including an advisory group hand-picked by the President himself last year—counter to the tax policies and defense investments of this administration, which are clearly increasing the resources of one region over another.

Let me state again, for the record, what I believe is necessary if we are to have a federalism that is new in fact as well as name.

The Federal Government must admit its role in redistributing resources among individuals and among regions, using its tax policies and programs to promote a national sense of well-being, a national sense of responsibility for the poor, the disabled, the handicapped.

The retarded youngster in Birmingham, Ala., should have the same level of attention and education as his counterpart in Rochester, N.Y.

The disabled worker in Detroit should have the same chance for rehabilitation as a disabled person in San Francisco.

Decent schools, adequate medical care, humane treatment of the elderly should be a right, not an accident of geography.

A serious, comprehensive, workable program for achieving a new federalism must be rooted in a recognition that the Federal Government has the broadest tax base, and that it alone can finance programs of national scope, programs of employment and health as well as defense.

Wherever possible, administrative responsibility for a program should be given to that level of government which has the greatest, direct interest in the success of the program.

New Federalism must begin the Federal assumption of the costs of income redistribution programs—AFDC, food stamps, and medicaid—thus allowing increased State assumption of the costs of public works and economic development programs.

The States—at least New York State—do not have the fiscal capacity to do both.

The administration promises that in the "Great Swap" the States will lose no money while gaining a greater control over programs.

It is difficult to assess the extent of Mr. Stockman's creative accounting in reaching this conclusion, but we can only hope it is not on the scale as the imaginative mathematics of his budget predictions of last year.

In any case, the revenue turnbacks that the President argues will help States pay for the 43 programs they will be given are both inadequate and unevenly distributed.

New York would be given $3.1 billion of programs to run and would gain only $359 million by substituting State for Federal excise taxes.

Instead of this random, hit-or-miss federalism that gives windfall profits to a few States and fiscal hardships to the others, we need a rational policy which recognizes that combating the effects and causes of poverty is a national responsibility.

At the same time, we should recognize that other functions—particularly the redevelopment of our capital plant—are best done on the State level.

During the past 7 years, we in New York have shown that, even when faced with the most intractable fiscal and economic problems, government can work.

We have held increases in State spending below the rate of inflation—at about half the rate of inflation—and far below the rate of increase in Federal spending.

As a result, we have been able to reduce taxes for businesses and for wage earners by over $2.3 billion.

Yet we have never abandoned our belief in the positive role that Government should play in strengthening our economy and improving our society, in creating hope as well as jobs, in fostering equality as well as prosperity, and our program in New York, after a loss of 700,000 jobs up to 1975, has resulted in a net job increase of 400,000 in the last 6 years. That's a turnaround of the kind we need at the Federal Government level and through programs like our transportation bond issue and the new transit authority capital program we are rebuilding our whole configuration of transportation. Unfortunately, we are facing losses of capital authority and loss of funds from the Federal Government.

We have undertaken the most comprehensive regulatory reform program ever undertaken at the State level.

We are strengthening employment and training programs, especially those designed to help people make the transition from welfare to work.

And we are directly supporting the expansion of cooperative research and development programs, involving both our universities and the corporate sector, to assure New York's place in the technological revolution that was stressed so well by Governor Brown, and we are reshaping our economy for tomorrow.

Most importantly, we have done all this without abandoning those most in need, without asserting that the poor are the cause of our economic difficulty rather than its victims.

Fifty years ago, a nation plunged deep in depression found that a Democratic government in New York State—the government of Al Smith, Franklin Roosevelt, Robert Wagner, Frances Perkins, Averell Harriman—offered the Nation both a philosophy and a practical program around which a national recovery could be built.

I am not given to political nostalgia, nor am I calling for ritual imitation of the strategies or programs of the New Deal. They were designed for a different time and a different crisis.

But I do not see how we can move away from the principles of the New Deal: From the nondogmatic, practical, humane approach to government that allowed Roosevelt and his colleagues to adapt the venerable principles of our republic to changing economic realities.

I recall the origin of this committee of which I once served came from the commitment of Harry Truman for full employment, and in 1948 when the committee was founded, it was Harry Truman's wish and objective that this committee issue an annual report on our progress toward full employment. I'm giving you that kind of thought from New York today. We are moving to a full employment economy by reducing taxes, containing the cost of government, and training people for jobs, and I hope that the same kind of experience that we have had could be of some benefit to the Federal Government.

I again quote the Wall Street Journal which said, "Supply-side economics could work providing you do it the New York way." And our product is now labeled "Made in New York," and I hope that some of the mistakes made by the Federal Government can be redressed and addressed and we can get this ship back on course again before we get into more trouble.

Thank you very much, Mr. Chairman.

[The prepared statement of Governor Carey follows:]

PREPARED STATEMENT OF HON. HUGH L. CAREY

Last year when I testified before the House Ways and Means and Budget Committees, I warned against accepting the false promises of the Program for Economic Recovery put forward by the new Administration. I based my warning upon the experience I had gained in helping steer New York State out of economic and fiscal crises which were every bit as grave as those now facing the nation. I warned against the fiscal recklessness of massive tax cuts, against the social recklessness of ignoring the needs of the poor, and against the economic recklessness of relying on ill-designed tax incentives instead of investing in human resources and public capital facilities.

It is now abundantly clear that the supply-side vision that guided the President's policy was deeply flawed. Instead of leading us to recovery, it has aggravated our problems. Business confidence has fallen in the face of soaring real interest rates and a plunging stock market. All that has trickled down to the poor in the past year is surplus cheese.

The President has become trapped by his own program. Last year he lobbied, with devastating success, for two policies: Cut taxes and cut government spending. His huge tax cuts now threaten such large deficits that he is forced to cut spending deeper and faster than is possible or wise for the American economy. But even these cuts do little to close deficits that, by any reasonable forecast, will traumatize our capital markets. The economy is being driven further and further away from recovery. Mr. Reagan claims that he does not want to change course in mid-stream. But it is easier to change in mid-stream than it will be to refloat the economy after it has run aground on the right bank.

The new federalism that was announced with such fanfare this year should not distract us from the deep economic crisis that confronts us. The fiscal "shell game" that the Administration has offered to play with State capitals will not restore American economic leadership, give jobs to the unemployed, or feed the hungry. The harsh winter of 1982 will be prelude to even harsher times unless we take corrective action now.

Administration spokesmen continue to challenge opponents to outline alternatives, only to ignore those alternatives when they are presented. Last year I outlined an economic strategy that included: targeted tax cuts and tax reforms to encourage investment and increase savings; reductions in federal spending at a level beyond those suggested by the President -- but not from the incomes of the poor; and public investment in human resources, capital facilities, and other national economic priorities. It is a balanced, fiscally prudent, and humane alternative.

Today I will outline a program for restoring healthy growth to the economy and that will allocate fiscal and administrative responsibilities for public investment among federal, state and local government in a way that will inspire efficiency but also balance responsibility with needs and resources. The program includes:

- o A rational tax reduction and reform package that encourages productive investment and savings.

- o A program of investing in education and training so that all Americans have the opportunity to participate in productive, well-paid jobs.

- A program to maintain our commitment to the economically disadvantaged and to reduce dependency on income transfer programs.
- A strategy to reduce unnecessary federal spending.
- A restructuring of federal-state relationships, with priority given to redefining responsibility for helping Americans in need, and for renewal of our capital plant.

Before I describe the details of this strategy, I would like to define the three basic concepts upon which it is based. The first is fiscal prudence. I share the President's concern with reducing spending and taxes. We have followed that goal with demonstrable success in New York. But we must do so in a balanced and planned way. I do not believe that a balanced budget is a prerequisite to economic recovery. However, I do believe that huge deficits will preclude renewed growth. In New York, we cut taxes from the fiscal dividend produced by stringent expenditure reduction programs. The result was renewed investor confidence. The President has helped create recession by cutting revenues below a fiscally prudent level. The program I outline in the following pages provides for more moderate, but more effective tax cuts, coupled with reduced federal spending that will restore business confidence.

My second principle is that renewed economic growth will result only from a balanced economic program. There is no simple solution that can be summarized in slogans fit only for bumper stickers or table napkins. Cutting taxes will not help the economy if the result is unfinanceable deficits. But cutting spending will also be counterproductive if it means that industry will not have skilled workers or if the nation's highways and bridges are falling apart. We have a complex economy and its problems can only be addressed through a far-reaching and carefully considered strategy.

My third principle is that we must ground our strategy in reality. Last year, the Administration sold its program on unrealistic assumptions about the economy. Budget Director Stockman has admitted that OMB computers were doctored to verify the Administration's overly optimistic assumptions. The Administration's forecast in March 1981 of the FY 1982 deficit was $42 billion. This has since been more than doubled. Yet the Administration still persists in projections that are unrealistic in this year's budget. Projections by the Congressional Budget Office, which provided much more accurate forecasts last year, show budget deficits twice as great as those forecast by the Administration for the three years beginning in FY 1983. It is difficult to conduct a rational debate on economic policy and to reassure the American people when there are such huge discrepancies between the Administration's premises and those of virtually every other participant in the discussion.

1. A RATIONAL TAX PROGRAM

The so-called Economic Recovery Tax Act of 1981 is an ideologically-motivated concoction of income tax cuts and special-interest giveaways, along with a few real improvements in the federal tax code. The result is a program that threatens enormous federal deficits, but which holds little promise of achieving the positive economic effects advertised by the Administration.

Changes in the structure of federal taxation were needed. Our tax system does discourage productive investment and savings; and it does encourage diversion of capital into unproductive tax shelters. The President deserves some credit for calling public attention to these problems. But the remedies he proposed, and those adopted by Congress have proved to be dangerous mistakes. Our first step in restoring fiscal stability and a sound economy must be to correct those errors. The place to begin is with modification of the income tax cuts enacted last year, both to reduce the revenue losses that have resulted and to distribute more equitably the benefits of tax reduction.

The National Economic Recovery Tax Act of 1981 contained massive cuts in personal income taxes -- but cuts that serve mainly to create enormous deficits and provide windfall gains to the rich. The working American whose labor provides the country with its food, consumer goods, and shelter has no place at this moveable feast. We must take the following steps immediately:

- Roll back the promised cut in rates in July 1982 from ten percent to five percent. This will restore $50 billion to federal revenues in fiscal 1983.

- Drop the third year tax cut from the legislation at least until economic and fiscal conditions justify it.

- Eliminate the provision for automatic indexing of the tax structure that takes effect in 1985. For the federal government to commit itself to indexing before the budget has been brought under control and the deficit sharply reduced, if not eliminated, is wildly irresponsible.

- Stretch the tax brackets for households earning less than $40,000 a year so that the generous increase in disposable income bestowed this year is distributed more equitably.

- Convert standard deductions into standard credits. Instead of deducting from taxable income $1,000 for each dependent, we should offer a tax credit of $230. This leaves tax revenues unchanged, but ensures that a child is worth the same in reduced taxes to all households, regardless of income. There is no reason why an American born to a high-income household should reduce that household's taxes by $500, while one born to a working household may be worth only $100.

These reforms would help close the deficit, while increasing the equity of our tax system.

Congress must also act immediately to correct the most glaring inequities of the business tax cuts enacted last year. Most significant of these are the new "net leasing" provisions. While I have advocated making tax credits partially refundable to struggling companies, the wholesale transfer of credits and depreciation allowances by highly profitable companies is clearly not an effective incentive and is creating a hemorrhage of revenues.

Even the <u>Wall Street Journal</u> has recognized that last year's leasing provisions were a mistake. In a recent editorial, the <u>Journal</u> described the new law as "a dud. It subsidizes losers; it subsidizes winners with enough overseas business to enjoy foreign tax credits; and it arbitrarily subsidizes capital-intensive industries over labor-intensive ones." The Journal is right. These provisions should be promptly repealed.

In addition to these changes in the Economic Recovery Tax Act, Congress should consider other tax measures that could help close the budget gap, without hurting low-income families, or discouraging savings and investment. For example, capping the deduction allowed for consumer interest charges on all purchases except automobiles would increase federal revenues by $4 to $5 billion in fiscal 1983. In 1979 only seventeen percent of all taxpayers took this deduction; a cap would probably affect less than ten percent.

The changes I have suggested will significantly reduce the projected deficit for fiscal 1983, and for the next few years. This must clearly be our first priority. But just as important in the long run will be the major changes in the federal tax code that are needed to ensure a more equitable and economically more rational taxing system.

We can begin with business taxes. Once our immediate fiscal problems have been resolved, Congress should take a second look at 15-10-5-3. While major reforms in depreciation were clearly needed, and while the Congress is to be commended for having addressed this issue forcefully last year, it now seems clear that 15-10-5-3 was not necessarily the most appropriate way to resolve the problem. First, it is extremely expensive. It will effectively reduce tax rates for many large, capital-intensive businesses to zero. Second, because its asset classifications bear little or no resemblance to real asset life, it can tend to distort investment incentives.

Third, it does not really reduce the uncertainties caused by fluctuating inflation rates. And finally, it does little to help new and small businesses, and businesses whose chief resources are human, rather than physical capital.

In the years ahead, Congress should examine alternative approaches to depreciation, particularly the first-year capital cost recovery system proposed by Professor Dale Jorgenson of Harvard. Depreciation reform should be combined with reform of the investment tax credit program. The existing credit, which in combination with accelerated depreciation is often excessively generous, should be replaced with special tax credits aimed at four objectives: stimulation of research and development; encouraging employment of the disadvantaged, as we do under the Targeted Jobs Tax Credit; encouraging construction of low-income housing; and stimulating investment in severely depressed areas.

In the long run, we should also examine other major changes in our tax system, including integration of corporate and personal income taxes, and increased exemption of interest and dividend income from taxation.

I do not wish to slight the many important and worthwhile changes that Congress enacted in last year's tax act -- measures such as expanded eligibility for individual retirement accounts, and expanded Subchapter S treatment. Nor do I deny the unpalatable nature of <u>any</u> rollback of tax cuts already enacted -- especially in the midst of a recession. But it is becoming clearer with each passing week that the nation's economy will not fully recover until we restore some stability and sanity to federal finances. The tax measures I have proposed are an important step in that direction.

2. INVESTMENT IN HUMAN RESOURCES

Few aspects of the President's program will prove more damaging to the long run health of the U.S. economy than its neglect of investment in our human resources through education, training and employment programs. Studies have proved, again and again, that investments in human capital have been as important as investments in physical capital in determining our real rate of growth. With the bewildering rate of technological progress and increasing imports of manufactured goods, education and training will be even more important during the next decade, if the nation is to remain competitive, and if Americans are to be prepared with the skills needed by our growing industries.

Investing in people is important not only to meet industries' needs but also to ensure that all able Americans participate in the economic process. Acquiring skills is the only way in which the economically disadvantaged can be lifted from the vicious cycle of disinvestment, discrimination and despair. In his budget message, the President claims that:

> "Government training in most cases has been expensive, often has been for people who would probably find work anyway, and too frequently has been for jobs that do not exist."

This is patently false, and contradicts scores of studies that have been undertaken to evaluate programs to educate and train the disadvantaged. Reviewing these studies, the National Commission for Employment Policy concluded:

- Every dollar invested in on-the-job training returned $2.28 in social benefits (which included increased goods and services as well as increased taxes to all levels of government and reduced welfare dependency).
- A dollar spent on Job Corps returned about $1.39 to society.
- A dollar spent on classroom training returned $1.14 to society.

And the compelling aspect of these findings is that the more disadvantaged the individual, the greater the rate of return. The facts are in clear conflict with the shallow rhetoric of this Administration.

The President is more than willing to provide massive tax subsidies for investments in plant and equipment that would have occurred anyway, or for massive mergers and takeovers that generate no new jobs, or to industries that produce unneeded products through outmoded means of production. He is unwilling to invest in our workforce through programs with a proven, profitable rate of return. What rate of return will the taxpayer earn on the Clinch River Breeder reactor, tobacco subsidies, and on an unnecessary fleet of of bombers?

The President's Secretary of Education admitted before the House Education and Labor Committee last May that: "The rationale for the budget cuts was not based upon any alleged failure of Title I. I know, and I can testify to this Committee, that our Title I programs are successful." Success in helping the educationally disadvantaged appears to slate a program for extinction.

Congress cannot condone the brutal cuts that the President proposes.

- o Federal spending on elementary and secondary education is being reduced from $7 billion in FY 1981 to $4 billion in FY 1985 (only $3 billion in constant dollars -- a cut of over 50 percent.
- o Aid to higher education would be cut from $6.8 billion in FY 1981 to $4.3 billion in FY 1985 (again, a cut of more than 50 percent in real terms).
- o Training, employment and labor services will be reduced from $9.8 billion in FY 1981 to only $3.6 billion in FY 1985.

These proposals add up to a shocking renunciation of any federal commitment to a rational and effective economic development policy. We will condemn millions of Americans to a marginal economic existence and we will all lose the potential productivity of those denied access to meaningful jobs.

For the Administration to argue that "the best contribution the federal government can make to the under-trained and unemployed is to encourage the steady expansion of the private economy" is to deny both our historical record and our present situation. The history of America in the post-war era makes it abundantly clear that trickle-down economics simply doesn't work. Those at the bottom of the economic ladder will rarely benefit from overall economic growth unless we act directly to assure that new opportunities are created for them. Moreover, the premise that this Administration's policies will produce such overall growth is obviously an uncertain one. So far, the principal achievement of the Administration's programs has been to swell the ranks of the unemployed by over one million and to erode the standard of living of all Americans not fortunate enough to benefit significantly from last year's tax cuts.

We cannot and should not expect private industry to provide all the education and training needed to make a welfare recipient, an unemployed steel worker, or a part time service worker employable in the new occupations generated by our technological revolution. Generally speaking, individual employers do not have the facilities, the expertise, or the resources to meet this need. It is equally facile to suggest that somehow the poor can pay for training and education themselves.

The public sector must play a role. But that role must be based upon an equitable sharing of fiscal and administrative responsibility between federal, state and local governments.

The New York State Experience

In New York State, we have recognized that a commitment to quality and equality in education is one of our strongest development needs. Yet our approach is in profound contrast with that followed by the President. Instead of walking away from our responsibility and invoking hollow slogans about localism and trickle down, I have proposed a far-reaching program through which the State will increase its aid to fiscally constrained and low-income school districts by $1 billion a year by 1985, which will increase the State's share of primary and secondary education from 40 to 50 percent. This will be achieved through the dedication of existing taxes and through the raising of new taxes. But I am confident that the people of New York recognize that spending on education is a crucial investment in our economy and in the future welfare of our citizens. We also believe that a restructuring of intergovernmental relations must take into account ability to pay. The President seems to regard fiscal capacity as irrelevant.

I would point out another critical difference between our program and the approach of the Administration. Part of the increased funding for education I have proposed would be financed through an additional one percent on the state sales tax. Yet my proposal includes refundable credits against the state income tax so that no-one earning less than $18,000 will pay any net increase. How different from the President who would deny income maintenance and services to low-income households in order to finance tax holidays for the truly greedy. When we all benefit from prudent public investments, we should all pay according to our resources.

A National Education, Employment and Training Strategy

The nation cannot grow, nor can we address the basic problems of poverty and low productivity, without a national strategy for investment in human resources. We must recognize that our present programs are needlessly complex, duplicative, and subject to the vagaries of annual appropriations.

What is needed is a complete restructuring of the system. A new employment and training system should integrate into one coherent structure all of the diverse and fragmented programs that the federal government now funds -- the state-administered employment service, the CETA program, vocational education, and the Work Incentive Program for welfare recipients.

This integrated network of programs should be administered at the community level by local or regional agencies, operating under state supervision and in accord with comprehensive state plans. The employer community should be actively involved in both the planning and delivery of on-the-job training and other services designed to help people secure stable private sector jobs, with some potential for advancement.

Workers could be eligible for training under this system -- as they are eligible for Unemployment Insurance payments -- on the basis of their participation in the labor force, or, in the case of welfare recipients, on the basis of demonstrated need.

Finally, a new employment and training system should be funded at a level and in a manner that reflects the crucial role of human resource development in determining our economic future. In order to provide secure and predictable funding, Congress should authorize funding of this new system on a long-term basis, and the level of funding available for employment and training services should be increased.

Experts in the field of employment and training have estimated that a system such as I have briefly outlined here could be established at a cost of about $20 billion. This would, of course, not be entirely new spending -- the new system would replace about $15 billion worth of categorical programs.

This is not simply an ivory tower proposal. Major elements of the program I have outlined here have been endorsed by groups as diverse as the National Governors' Association and the National Alliance of Business. With CETA coming due for reauthorization in September, Congress has an opportunity to completely overhaul the employment and training system. Nothing it does in 1982 will have a greater effect on our economic future.

A comprehensive human resource development policy should of course go beyond the confines of the employment and training system. We must begin to provide employers with some of the same incentives for investment in people that our tax system now provides for investment in buildings and machines.

We must recognize that this strategy cannot be subject to the vagaries of annual appropriations that have weakened the present structure. A unified system requires a stable source of funding, equitably allocated among states. I propose that we set up a series of state trust funds, analogous to but independent of the Unemployment Insurance system, perhaps funded from an employer/employee tax or through an excise tax on imported oil. Effective investment in human resources cannot be achieved without commitment of public resources.

3. MAINTAINING OUR COMMITMENT TO THE DISADVANTAGED

No one can deny that the President inherited a federal budget that was out of control. Inflation had swollen entitlement programs beyond recognition, and hasty responses to the energy and urban crises of the 1970s had created needless proliferation and duplication of programs. I can sympathize with the position the President faced last year because it is very similar to the one I faced in New York in the winter of 1975. However, I cannot sympathize with the President's single-minded approach to budget cutting that denies food and basic services to the poor while providing the military with more resources than they can possibly absorb. Whatever rhetoric the Administration uses in Washington about the maintenance of a safety net for the "truly needy," it is clear to those of us who must carry out the cuts that the safety net is no more real than the emperor's new clothes. We are gambling with the lives of millions of Americans.

The President's new proposals will be an intolerable burden on poor Americans, already reeling from the cruel cuts imposed last year. AFDC will be slashed from $8.5 billion in FY 1981 to only $5.4 billion in FY 1983. Social services will be cut from $6.5 billion in FY 1981 to $5.1 billion in FY 1983.

The President intends to solve the problem of poverty by defining it away. The "truly needy" will decline in numbers not because the private sector is providing them with jobs but because capricious and cruel changes in eligibility requirements will deny benefits to the very people that Congress intended to help when it created the programs. Without training programs that would render them employable, cut off from the support services that would help them work, and penalized with a 100 percent tax rate as a reward for working, the poor are being forced back on welfare, where dwindling benefits and harsh administrative requirements threaten to destroy the basic system. Commenced with the evisceration of our income support, the President is planning to throw these programs back to the states as part of his new federalism.

We cannot discuss a program for economic recovery that is predicated upon the impoverishment of millions while reconcentrating wealth into the hands of a few. It is socially reckless to hold up the victims of our ailing economy as the cause of our problems. In the last decade, welfare and Foodstamps helped one in four Americans. These are not idle, unmotivated individuals as the Administration would have us believe. Most of them, of course, are children. Some are elderly or disabled. And many are hard working, productive Americans who because of economic adversity or personal difficulties temporarily need help. Can we, the richest and most powerful nation in the world, honestly claim that we cannot afford to assist our own citizens in their moments of need? Voluntarism will not feed or shelter the hungry and homeless. Less than ten percent of the federal budget is spent on programs targeted to those with low incomes. Yet more than one third of the proposed cuts are inflicted on these programs.

Criticism of these budget cuts is now being raised by both Republicans and Democrats. It is not too late to save the basic structure of our income maintenance system for those who cannot work. We can moderate the tax cuts, scale back increases in defense spending, and restore income and service assistance programs to levels compatible with human needs and human dignity.

Adequate income maintenance and supportive services are essential; but by themselves are not an adequate answer to the problems of poverty. A coherent strategy for extending economic opportunity to all Americans must include two components. It must concentrate our economic development resources and incentives on the revitalization of chronically depressed areas where large numbers of poor people live; and it must provide direct assistance to individuals who need help improving their positions in the job market, regardless of where they live.

Some of the initiatives I have already identified -- tax credits for investment in depressed communities and for hiring the poor, and an increased federal commitment to employment and training -- would support this dual strategy. But other policy initiatives will be needed as well.

First, we need to assure that the economic development resources of all levels of government -- federal, state and local -- are effectively integrated in a coherent, concentrated effort to create jobs in the nation's poorest communities. This kind of approach is already in place in New York. For example, the New York State Urban Development Corporation's targeted job development program provides flexible financing to new business in some of our most depressed areas.

Second, we need to strengthen our national commitment to assisting the poor to become self-reliant. The Congress could begin this process by restoring the incentives to work that were so mindlessly removed from the AFDC program earlier this year. A further step could be to begin using the resources of the welfare system more effectively to support the transition to regular employment. For example, in New York we have established a new program, called the Temporary Employment Assistance Program, under which home relief grant funds can be used to finance private sector on-the-job training for employable recipients. We are now prohibited by federal law from doing the same for AFDC recipients. The law should be changed.

We also need to help young people from low-income families -- those most at risk of becoming dependent on welfare -- to make the transition from school to work. The rate of unemployment among minority youth, which chronically exceeds 40 percent, is not a sign that the labor market doesn't work well for such youth. It's a sign that the labor market doesn't work at all. The national employment and training strategy I outlined earlier should give special emphasis to the needs of these young people. But we also need to commit ourselves to a long-term effort to strengthen basic education in low-income areas. I recognize that this is, and must remain, primarily a state and local responsibility. But there is a role for the federal government in directing our educational resources to those who need them most.

For when the President says it is not the federal government's role to redistribute resources from one region or community to another, or to those most in need, he is simply wrong. He is wrong philosophically, and wrong historically. The constitution that

4. A BALANCED APPROACH TO SPENDING CONTROL

The alternative tax cut program I have described will help both stimulate economic development and reduce the enormous federal deficits projected for the years ahead. Nevertheless, if we are to stabilize federal fiscal policy, we must complement a sound tax program with controls on spending. Domestic spending can be reduced prudently and humanely.

First, just as states and local governments have had to do for years now, the federal government should trim its payroll. A two percent reduction in federal employment would not significantly effect the quality of public services, and it would save billions of dollars.

There are many other examples of possible savings.

- o There is no valid reason to continue tobacco subsidies and various crop deficiency payments. All of these subsidies should be eliminated.
- o The synthetic fuels program has failed to demonstrate that it can significantly and efficiently reduce our dependence on foreign oil. It is simply a massive subsidy to some of the nation's richest corporations. Federal synfuels funding should be limited to research and development.
- o The breeder reactor program should be terminated.
- o Development of an effective health care cost containment program could save billions of dollars annually in Medicare and Medicaid expenditures.
- o Use of a more accurate measure of inflation than the Consumer Price Index for indexing entitlement programs could save several billion dollars annually.

These are just a few examples; but the overall direction is clear. It should not be the job of the federal government to subsidize the incomes of individuals who don't need help, or private companies that should be left to either succeed or fail on their own.

New York's experience in dealing with its fiscal problems in the mid-1970s holds some important lessons in this regard. We were able to hold the line on State spending, and in some areas to reduce it. But we did so without cutting welfare benefits. We dramatically improved services in some areas, such as programs for the mentally retarded. And rather than forcing local governments to absorb cuts in State spending, the State picked up local costs for courts, for the SSI program, and for the City university. As the Wall Street Journal said in an editorial in March of 1981, Washington would do well to follow New York's example.

We must also curtail the massive planned increases in Defense spending. I am committed to a strong national defense but I do not believe the President's program is necessary to achieve that goal. The President seems to be convinced that in the area of defense, bigger is always better. He thus fails to recognize that a sound defense strategy cannot emerge from an inability to distinguish between muscle and fat; and that the total federal budget cannot be controlled as long as the Pentagon's budget is out of control.

Enormous waste in military spending is not a figment of the liberal Democratic imagination. Budget Director David Stockman has suggested that as much as $30 billion could be cut from the Pentagon budget without adversely affecting our defense posture. This year, the Congressional Budget Office identified thirteen areas where $44 billion could be saved by FY 1987. And in 1981 Senators Barry Goldwater and Howard Metzenbaum jointly conveyed their concerns in this area to Secretary Casper Weinberger. "Waste and inefficiency," they wrote, "have over the years become a way of life for too many in the Defense Department..., it is pure and simply the result of a system that permits DOD to operate as though the public purse has no limits."

The Administration is perpetuating this waste by its reliance on technologically complex major weapons systems that many critics believe are not sufficiently flexible to respond to many of the military situations that may arise in the years ahead. The B-1 bomber, for example, will be enormously expensive, yet have very limited utility. Indeed it could be totally obsolete before it is fully deployed. Other initiatives, such as the recommissioning of battleships, appear to be symbolic gestures, without strategic value.

The President's program also fails to recognize the disruptive effects that this massive military build-up would have on our economy. The huge increases in defense procurement included in his budgets will strain the capacity of our defense industries. As these industries rush to expand, capital will be diverted away from more productive civilian uses, and the upward pressure on interest rates will be increased. The shortage of engineers and other technical personnel in civilian industries will worsen. The prices of skilled labor and strategic materials will be bid up.

If we are to create what is -- let us be honest about it -- a wartime military establishment, we will suffer the ills of a wartime economy -- a weakening of civilian investment, sustained inflation, and recurrent shortages.

The President's colossal "rearmament" program mocks his concern for reducing the federal deficit, curbing inflation, and restoring our economy. Despite its rhetoric, the President's budgetary strategy ultimately has little to do with restoring our economy -- or even with reducing government spending. It is simply a massive shift of resources from domestic programs to the military. As I told the House Budget Committee last March, it can be summarized in one sentence: Reduce social spending without regard to consequences; increase military spending without regard to need.

Greater discipline in federal spending is clearly necessary. This is not because the aggregate level of federal spending is in some vague way "too high" for our economy to sustain -- it clearly is not -- but because we need to bring expenditures and revenues into some more reasonable balance; and because some federal spending is clearly wasteful or even harmful to our economy.

Unfortunately, the approach to spending control proposed in the President's budget is simply unworkable. Fortunately, it is not too late to chart an alternative course.

5. THE NEW FEDERALISM

The President's new federalism proposal is clearly an attempt to draw public debate away from his failing economic program. It is, equally clearly, a prescription for the final unravelling of those elements of rational and equitable public policy that would remain if the new round of cuts in domestic spending proposed for 1983 is enacted. It is not a program for a "new federalism." It is a program for a "new feudalism."

I, and my fellow governors, have long supported reforms in the relationship among federal, state and local governments that would avoid duplication and inefficiency, encourage coordination, and restore equity. But these reforms must be carefully weighed and designed in an atmosphere of trust. In the last few days, we have communicated our views to the President, and he appears willing to defer action and to rethink some aspects of his proposal. I would like to offer some suggestions on the direction the Administration and the Congress should take in considering intergovernmental reform.

The Basic Principles

Any "new federalism" must be based upon a coherent set of principles, not upon accounting gymnastics. Yet last year, in a widely publicized press interview, the President flatly stated that he was opposed to any redistribution of resources among regions, and to any "sorting out" of fiscal and administrative functions among different levels of government. This view runs counter not only to most of this country's history but also to the almost unanimous views of everyone that has studied the issue -- including an advisory group of those hand-picked by the President himself last year. Criticisms have come from all levels of government and from the full political spectrum.

Before I address the specific faults with the President's plan, let me lay out the principles that should guide federal-state relationships -- principles that have been espoused by the National Governors' Association, the Advisory Commission on Intergovernmental Relations and other bi-partisan groups.

- o First, the federal government must play a major role in redistributing resources among individuals and among regions.
- o Second, wherever possible, the region benefiting from a particular project or program should pay for that program.
- o Third, wherever possible, administrative responsibility for a program should be given to that level of government which has the greatest direct interest in the success of the program.

The federal government has the broadest tax base and through the collection and distribution of revenues can allow all of us to share in our rich national endowment of resources. That function is at the core of our federal structure. It is vain to assert that the federal government has no role in redistributing resources when it does just that with every defense contract or facility and with every highway project, Corps of Engineers project and even with the very structure of the federal tax system. In many cases, it is more efficient to collect taxes nationwide, and even to administer programs from Washington.

The President's Proposals

Against any rational criteria, the President's new federalism proposals are a failure. He is not so much "sorting out" functions between the federal and state governments, as he is simply delegating almost all social programs to state government. There are four fatal flaws in his approach.

First, the President's "new federalism" rejects a half century of progress toward full recognition that poverty is essentially a national problem -- a product of economic and social dislocations that are regional or national in character, and that individual states cannot effectively deal with on their own. From the Social Security Act in the 1930's, to Food Stamps and SSI in the early 1970's, both Democratic and Republican administrations have recognized the wisdom of seeking national solutions to the problems of poverty. Now the President would have us cast aside this heritage.

I certainly do not agree with those who suggest that the states are somehow inherently less humane, or less attentive to the poor, than the federal government. And there are sound reasons for continuing state and local <u>administration</u> of many of our social welfare programs. But experience clearly shows us that if decisions about benefit levels and financing arrangements in these programs are left completely to the states, the pressure on individual states to gain some marginal economic advantage, real or perceived, by neglecting the needs of the poor, will be enormous.

My second objection to the President's scheme is that it is another instance of the Administration using unrealistic numbers to support their case. It is difficult to assess the extent of these accounting games until the full details of the program are revealed. But there is a wide discrepancy between the Administration's claim that the AFDC/Foodstamps and Medicaid swap would benefit the states by $2.6 billion in 1984, and the Congressional Budget Office estimate that states would lose $1.5 billion.

Third, the Administration is being less than forthright about the exact nature of the proposed federal assumption of Medicaid. It is not clear whether the Administration proposes to assume all the optional benefits offered by states. Many states extend Medicaid to the medically indigent and to SSI recipients to fill the gaps in Medicare coverage. The "savings" to the states may be more apparent than real. The Administration has also estimated AFDC costs in FY 1984 at $2 billion below their present level, again an unrealistic assumption even with the proposed eligibility changes.

Fourth, the revenue turnbacks that the President argues will help states pay for the 43 programs they will be given are both inadequate and unevenly distributed. New York would be given $3.1 billion of programs to run, and would gain only $359 million by substituting state for federal excise taxes. Phasing out the proposed Trust Fund and turning the taxing power back to the states is obviously a completely unrealistic idea.

The "new federalism" is not a serious attempt to sort out functions between the federal government and the states. It is from one perspective a continuation of the Administration's war on the poor; from another, it is simply a diversion, aimed at distracting Congress and the people from our present economic plight. In no sense is it a serious reform proposal, and it does not deserve to be considered as such.

An Alternative Approach to Reform

I do not mean to suggest that reforms in our intergovernmental structure are not necessary. In the years ahead -- after our economy has experienced a sustained recovery, and some sanity has been restored to the federal budget -- it should be a high priority for both the federal government and the states.

The central focus of these reform efforts should be an increase in federal responsibility for income maintenance and medical care programs, and an increase in state responsibility for construction and maintenance of capital facilities.

I have already alluded to some of the reasons why programs aimed at helping those in need should be considered a national responsibility. The best way to meet this responsibility is through comprehensive reform of welfare and Medicaid programs at the national level. Such a reform program should include creation of a uniform minimum benefit, with regional variations, fully funded by the federal government. It should cover both the non-working and working poor, and should provide fair and reasonable work incentives. In the area of medical assistance, increased federal responsibility for meeting the cost of essential health care for the poor could be combined with much more stringent mandates for controlling total program costs.

The incremental cost of these reforms would be relatively modest -- perhaps $12 to $15 billion. Compared with the President's proposals for military spending, it could even be called trivial. And these reforms could be phased in over several years, to minimize the short-term budgetary impact.

Just as important as reform of our social welfare and health programs is a restructuring of the programs through which we finance capital facilities.

Since the days of Alexander Hamilton, the development of essential public works -- canals, ports, railroads, highways, airports, water supply systems, waste management systems -- has been one of the fundamental bases of our prosperity. Yet during the past decade there have been all too many signs of a long-term reduction by the federal government, the states, and our local government in their commitment to the development and maintenance of basic infrastructure.

The statistics are grim:

- It has been estimated that one out of every five bridges in the United States requires reconstruction or major rehabilitation.
- The interstate highway system, which now carries 20 percent of the nation's vehicular traffic, will in the years ahead require reconstruction at the rate of 2,000 miles per year.
- In many cities, the replacement cycle for water supply systems have been stretched out to more than two hundred years. It has been estimated that to keep those systems functioning, $75 to $110 billion in new investments will be needed in the next ten years.
- As world demands for American grain and American coal rise, we will need to expand our major ports. Ships now lie at anchor for a month or more at Hampton Roads waiting to take on coal.
- It has been estimated that in New York City alone, $40 billion in capital improvements will be needed in this decade.

A book recently published by the Council of State Planning Agencies bore a title that labeled appropriately the prospect we will face if our investment in public facilities is not increased. It was called "America in Ruins."

If this nation is to prosper in the decades ahead, it must commit more of its resources to maintaining essential infrastructure, and to meeting emerging needs -- for example for the rail and port facilities we need if we are to increase our coal exports to meet world demands. States can only meet these needs if they are provided with the resources, either through federal assumption of welfare or through more direct federal assistance.

One of the nation's highest priorities should be to develop an overall national policy concerning maintenance and improvement of our basic economic infrastructure. Such a policy should establish major national objectives -- for example, ensuring the reconstruction of our interstate highway system on a twenty-year cycle -- and clearly define the respective roles of the federal government, the states an the private sector in meeting those objectives.

As a general rule, the federal government should get out of the business of selecting, financing and managing individual capital projects. It should set overall priorities, and leave actual program management to the states.

An example of this approach is the Moynihan-Domenici water resources bill, which was first introduced in the Congress in 1979. This bill would have converted a number of federal programs relating to water resource management, including those of the Army Corps of Engineers, into block grants to the states, with a 25 percent state matching requirement. It would not increase federal costs one cent. Indeed, because it would largely eliminate project-by-project pork barrelling on fiascos such as the Tellico Dam and the Tennessee-Tombigbee waterway, it would probably effect substantial savings in the long run.

But it would allow the states to develop more rational, longer-range plans for maintenance and development of water resource systems. States would have a strong incentive to invest federal funds responsibly and wisely because of the matching requirement. They would not be able to view federal water project funding as "free money," as is often the case with Corps of Engineers projects.

The federal system for financing highway maintenance also needs reform. A first step might be to turn back some portion of federal gasoline tax revenues to the states, in proportion to their respective shares of total revenues collected, to finance maintenance of transportation facilities -- not just federal highways, but local roads, rail systems, and port facilities as well. In order to secure adequate funds for this purpose, the Congress should consider conversion of the gasoline tax to an ad valorem tax, or imposing a tax on imported oil. The proposed excise taxes are simply not adequate.

As the states have developed coherent plans for financing transportation infrastructure, the federal government should consider simply abolishing the Highway Trust Fund altogether, and let the entire gasoline tax revert to the states.

Even with changes such as these, there will always be a need for direct federal involvement in projects of major national importance. Port improvements designed to expand our capacity to export coal should, for example, be a high national priority. Direct federal financing would be the quickest, simplest and most effective way to secure these improvements.

In calling for a renewed commitment to infrastructure maintenance, I am not attempting to shirk state responsibilities. New York has already demonstrated its commitment, through initiatives like the transportation bond issue of 1979, and the multi-billion dollar capital program approved in 1981 for the Metropolitan Transportation Authority. We will do our part -- but Washington must do its part as well. This must be the basis of the new federalism.

CONCLUSION

In recent years, many of our state administrations have shown that, even when faced with the most intractable fiscal and economic problems, government can work. In New York and elsewhere, we hae shown that spending can be controlled, and budgets can be balanced without abandoning government's positive role in strengthening our economy and improving our society.

The federal government has much to learn from our experience and our example. When the President says there is no alternative to his program, he is simply wrong. His policies have produced an unworkable budget. Members of Congress, the nation's governors, and the business community all know it is unworkable.

The proposal recently advanced by Senator Hollings has some ingredients fro a way out of our current dilemma. I have tried today to present some others. In the months ahead, let us all work together to build a budget for 1983 that will restore fiscal stability, and provide a framework for both renewed growth and expanded economic opportunity.

Representative REUSS. Thank you, Governor Carey.
Governor King.

STATEMENT OF HON. EDWARD J. KING, GOVERNOR, STATE OF MASSACHUSETTS

Governor KING. Good morning, Congresswoman Heckler, Congressman Brown, members of the committee. It's a pleasure to be here today to speak to you about something I take great pride in, and that is the revitalization of the economy of the Commonwealth of Massachusetts and our experiences with proposition 2½.

It has long been my conviction that a policy of limited taxation and incentives for economic expansion are the only way we can insure that opportunity will exist for all of our citizens in the future.

It was clear from the outset of my administration that the greatest deterrent to social advancement and progress was our deteriorating economy. Changes had to be made.

During the period of 1970 to 1978, the economy of Massachusetts was in decline. Our per capita personal income dropped from 10.2 percent above the national average to 3.4 percent. Unemployment was always above the national average. And our total tax burden, as a percent of personal income, went from 3 percent below the national average to 11.3 percent above the national average.

The time for talking and taxing was over. What was needed was an aggressive strategy that would provide a probusiness environment that would allow for a competitiveness between Massachusetts and other industrial States, a program that would attract new investment and employment opportunities. To achieve this, three things had to be remedied:

One, the cost of State government in Massachusetts had to be cut.

Two, business incentive programs needed to be improved and tailored to the needs of our business community.

Three, communications between the business community and State government had to be strengthened and properly directed through regulatory reform and appointments to key posts.

All of these efforts were undertaken with one important objective in mind: To provide opportunity to the widest range of people possible.

In 1979, to begin our tax reduction program, I proposed a zero tax cap on local spending that was eventually enacted by our legislature as a 4-percent tax cap.

This effort forced cities and towns to take a cold and analytical look at the quantity and quality of local services being provided.

The first year of the tax cap resulted in a reduction of $30 million in property tax levies, the first such reduction in 36 years. However, fiscal 1981 saw an 11.5-percent increase in tax levies of $345 million. This occurred because of tax cap override provisions which the legislature added to my proposed bill. Two-thirds of the municipal governments overrode the 4-percent tax cap, demonstrating their desire to spend.

However, during this 2-year period, State aid to cities and towns increased by 22 percent in fiscal 1979 and an additional 18 percent in fiscal 1980. These increases in aid were further enhanced by the Commonwealth's assumption of the court system which had previously been assessed to municipalities, and expanded State participation in capital construction projects, such as wastewater treatment facilities, sewer construction, off-street parking, and trade and convention center facilities.

This additional aid should have translated into property tax reductions. When property taxes remained high after record amounts of local aid, the voters responded.

The taxpayers were angry that their desires were being ignored and the result was proposition 2½, the referendum which mandated a property tax cut of $385 million statewide. With this property tax limitation in place and applicable this year for the first time, the old process for financing municipal budgets has been radically altered. It is interesting to note that, had my proposed zero tax cap been implemented without override provisions by the legislature, a more moderate program of tax reduction would have occurred producing approximately the same dollar savings.

The upward spiral of our total tax burden was proceeding at a rate that was well beyond our ability to pay. I knew it, the voters knew it, and they responded with proposition 2½ with a landslide margin.

Proposition 2½ required cuts in fiscal year 1982 property tax levies of about $385 million and another $150 million loss in motor vehicle excise receipts.

Not surprisingly, the reaction of municipal governments was to seek a substantial increase in State aid to cover this shortfall.

Last year, after much debate, we sent back an additional $265 million in State aid, bringing our total local aid package to $2 billion representing a 15-percent increase in local aid.

Please note chart 1 shows the effects of proposition 2½ before we distributed any new local aid. The communities in red are those which would have been forced to cut spending by as much as 15 percent because they exceeded the property tax levy mandated by proposition 2½. The darker the red, the deeper cuts. In green are those communities which would still be able to raise property taxes because they were already below the levy.

Chart 2 shows these same communities after the distribution of $265 million in new local aid. There are still communities which have had to reduce spending, but as is clearly seen, the new aid had a dramatic effect.

Fewer communities are "in the red," and even those cities and towns which must still reduce spending have received assistance and are less intensely impacted.

Politicians said the cuts couldn't be managed; but we have proven them to be wrong. This extra State aid was accomplished through a strict attrition policy reducing the number of State employees and a strong economy. We have reduced our State work force by approximately 15 percent during my term of office. And our collection of revenues have consistently been higher than our projections.

It is interesting to note that not only has the tax burden come down since proposition 2½, but the tax structure has been drastically altered.

The share of revenues from the property tax has dropped from 43 percent in 1975, well above the national average of 23 percent, down to 32 percent in 1982 and will fall even further in 1983. Property taxes as a part of personal income has come down from their astronomical height of 7.5 percent in 1975 to 4.6 percent in 1982.

Our efforts have been directed toward bringing the Massachusetts tax burden back in line with the national average.

It is a fact that during the 1970's our comparative standing on taxation became unfavorable. We became a noncompetitor.

My efforts have been to systemically bring us back in line with the national average, to make Massachusetts an attractive competitive economy again. I am proud to say that we have achieved this goal and even exceeded our expectations by dropping the level of taxation 0.6 percent below the national average this year, and we expect the trend to continue next year.

The Commonwealth of Massachusetts is demonstrating that government can improve productivity and economic growth through limiting taxation and conservative expenditure policies.

Chart 3 demonstrates that as taxes increased in the period 1970 to 1978, income fell and, conversely, as tax burdens declined, personal income and employment increased dramatically. This reduction in the rate of taxation, coupled with our growth in personal income, represents a $1.95 billion tax cut per year in Massachusetts.

There are varying labels for this economic theory. I don't care to label a theory but I can tell you, these charts demonstrate facts and performance, not theory.

The decreasing rate of taxation has brought about the revitalization of our economy and a growth in personal income that is unprecedented in our State's history.

If you look at the period between 1970 and 1978, the Massachusetts total tax burden increased from 3 percent, which was the national average, to 17.6 percent which was 11 percent above the national level. We went from the 22d to the 5th highest tax burden in the Nation.

A major reason for this was the enormous increase in the cost of welfare. Welfare costs in Massachusetts became the second highest in the Nation in 1978.

Our welfare costs had to be controlled. But not at the expense of needy recipients, but by better management of our welfare system.

In fact, in each of my 4 years as Governor, I have raised benefit levels for our welfare recipients.

Our administrative overhead is a very low 5.6 percent, we have developed extensive use of data processing, and we have centralized the policymaking and management resources.

This, in turn, has allowed us to put more of our resources in the field offices and maintain a higher quality of service.

The error rate has been reduced by over 50 percent during my term of office.

And with regard to welfare fraud, again we have made substantial progress.

In the last 3 years, welfare fraud complaints have multiplied thirteenfold—from 3,100 to 42,000.

In 1981 our battle against welfare fraud has resulted in over 660 guilty findings, 16 times the 41 such findings the year before I took office.

I have also instituted a system for curtailing fraud and abuse within the welfare program. Our wage match program involves comparing social security numbers of welfare recipients with department of revenue data on wage earners in the Commonwealth.

Based on work incentives, wage match initiatives, and administrative improvements, we have moved almost 13,500 cases from the rolls toward self-sufficiency and saved over $50 million on an annual basis. Another 5,500 have been removed from welfare rolls because of changes in Federal eligibility requirements, making the reduction over 18,000 cases.

In addition, our child support enforcement program, which collects payments for child support from absentee parents, is the second most effective program in the country and collects over $3 million per month.

Our fraud investigations are directed at health care providers, absent fathers, State employees, and recipients.

These efforts, along with a new centralized postaudit function, provide both a deterrent to those contemplating an attempt to defraud the government and a means of reclaiming illegally disbursed moneys.

These unglamorous, yet essential, reforms have produced a system that runs better and enjoys a higher degree of public support.

We have also introduced a new program that will assist certain welfare recipients in entering the labor force.

The degradation of never having the opportunity for gainful employment is a cruel reality of the welfare legacy in America.

Our program is a mandatory program, but it is fair. It is controversial but no government action that attempts to change a pattern of two previous decades can come about without controversy.

However, in Massachusetts we have forged a coalition between advocacy groups, legislative interests, and my administration.

Our comprehensive work and training program requires that applicants and recipients seek, accept and maintain employment in the unsubsidized economy.

The fairness of this program lies in the emphasis put on meaningful employment. First through assistance in job search techniques, such as résumé writing, through skills training such as learning English as a second language and in advanced training, such as vocational training in the computer field, we are trying to help people get into the workplace.

If no work experience exists, we provide for a work experience in the nonprofit sector or, if necessary, a supported work environment to overcome long-term barriers to employment.

Finally, we will support individuals through educational programs that are likely to produce employment opportunities.

Although this program is mandatory, it is fair, and it will better help assist recipients of welfare to become economically self-sufficient.

There is a point here that must be clear. Since welfare-related expenses make up 30 percent of our State budget, the budget will never be managed until welfare is properly managed. In that the budget determines the level of taxation, taxes will never be stabilized or lowered until the budget is controlled, and unless taxes are reasonable, we lose our industries, our jobs, and opportunity for those who are in need.

I have a propeople philosophy. Some people say I am probusiness. So be it. My philosophy, however described, is not only for the sake of corporate Massachusetts but for the sake of our citizens, the people who work in our factories and seaports. This is the driving force behind our tax cutting, business incentives program.

Commencing in 1979, income taxes have been reduced; capital gains taxes have been reduced; auto excise tax has been reduced; real estate taxes have been reduced; for the first time we have a $60 million tax cut for renters. Renters are able to deduct one-half of the rent from their personal income. Unemployment compensation taxes have been reduced; and I have recommended to the State legislature that the 7.5-percent tax on personal income be eliminated, one-half in fiscal 1983 and one-half in fiscal 1984.

This tax was instituted by my predecessor as part of the enormous tax increase in 1975, the largest tax increase in the history of the Commonwealth. As chart 3 has demonstrated, it is at that time that the Massachusetts economy was crumbling. This surtax, which is a tax on a tax, represents $160 million of revenue that the State will return to our citizens. I have proposed to the State legislature that we eliminate this tax over a 2-year period, $80 million each year, a total of $160 million in fiscal 1984.

We created a campaign with the help of the State legislature and the private sector to let people know they should "make it in Massachusetts" and that we want their business. Between 1968 and 1978, we had a net loss of 36,000 manufacturing jobs. Weekly, we were hearing that companies were fleeing, and in 1975 we were ranked as the third worst business environment in the United States. We saw large corporations moving to New Hampshire to avoid our oppressive tax burden and antibusiness climate.

As your own staff study cited on page 26, my predecessor blamed Massachusetts relative economic stagnation at least in part on energy costs.

Massachusetts has historically relied on imported oil as its major fuel source. The huge increase in oil prices since 1973 have indeed had significant impact on our State's economy.

We have reacted vigorously to the challenges posed by those oil prices. For instance, one of the most successful measures we have enacted is the conversion of major utility plants from the burning of expensive imported oil to the burning of cheaper domestic coal.

There are now two plants fully converted to coal, another plant expected to be burning coal within the month, and at least four others presently in the planning process.

When our coal conversions are completed, the converted plants will save the consumers and industries of Massachusetts over $396 million a year.

We recognize that reducing our reliance on expensive imported oil is vital to the health of our State's economy—and we are working vigorously toward that end—but we took action and we are going to take more and not just talk about it.

It is as cold in New Hampshire as it is in Massachusetts. Our weather hasn't changed since I've been Governor but our attitude has, and our economy is showing results. New Hampshire had growth because they had an aggressive prodevelopment climate. We took a page from their book—rolled up our sleeves, and brought 200,000 new jobs back to Massachusetts.

For years, New Hampshire was the only State in the Nation with no sales tax and income tax. In the early 1970's, growth for New Hampshire was much higher than in other Northeastern States that had higher taxes. This statement holds true whether one measures growth in per capita or total income terms. Furthermore, New Hampshire has had a dramatically lower unemployment rate in recent years in comparison to the other States. New Hampshire was growing because the cost of doing business there was lower.

In Massachusetts we reopened communications with our business community. We told business we needed and wanted their help. We wanted all of our people to have the dignity of meaningful employment. We wanted people off government subsistence programs and into the private, unsubsidized economy. For example, we began to work closely with the Massachusetts High Technology Council. As you may know, the high tech firms, many founded in the 1960's and 1970's, employ approximately one-third of the State's manufacturing force. I have included material in my testimony which compares the cost of operating the same plant in five States and the tax burden on a professional employee at a salary of $20,000 in the same five States. This analysis was done by a firm which is a member of the high technology council, and in 1976 as part of the decisionmaking process on the location for a new manufacturing facility.

Obviously, the fiscal affairs of a State are factored in the businesses' decisionmaking process. As a result of our efforts with the high technology council, we have formulated a "social contract" which is a bilateral promise that states, if my administration reduced the tax burden in Massachusetts to a competitive level, the high technology industry would create 60,000 jobs in the Commonwealth over 4 years. The goals of both the high technology council and the Commonwealth have been achieved. We created a partnership with our industries that created opportunities for our citizens and, in so doing, reduced oppressive tax burdens on them.

Finally, if government is to be efficient, its regulations had to be simplified. In response to this need, I created a commission on regulatory reform.

The purpose of the commission was to adopt new policies and recommendations to reduce unnecessary and burdensome regulation in both the public and private sectors. These recommendations are, and will continue to be, promulgated through the executive, legislative, and judicial branches of State government.

Massachusetts has made great progress in the last 3 years. I consider us to be a great American success story. We accepted the challenge confronting the State and our attitude was positive.

We have tapped the imagination and creativity of all sectors within the Commonwealth with one goal, to make Massachusetts a better place to live and work.

[The material attached to Governor King's statement follows:]

CHART 1

ANALYSIS OF FY 1982 IMPACTS OF PROPOSITION 2 1/2 IN MASSACHUSETTS
BEFORE ANY DISTRIBUTION OF LOCAL AID
LOCAL PROPERTY TAX LOSSES ARE SHOWN IN RED, GAINS IN GREEN
PREPARED BY MITRE

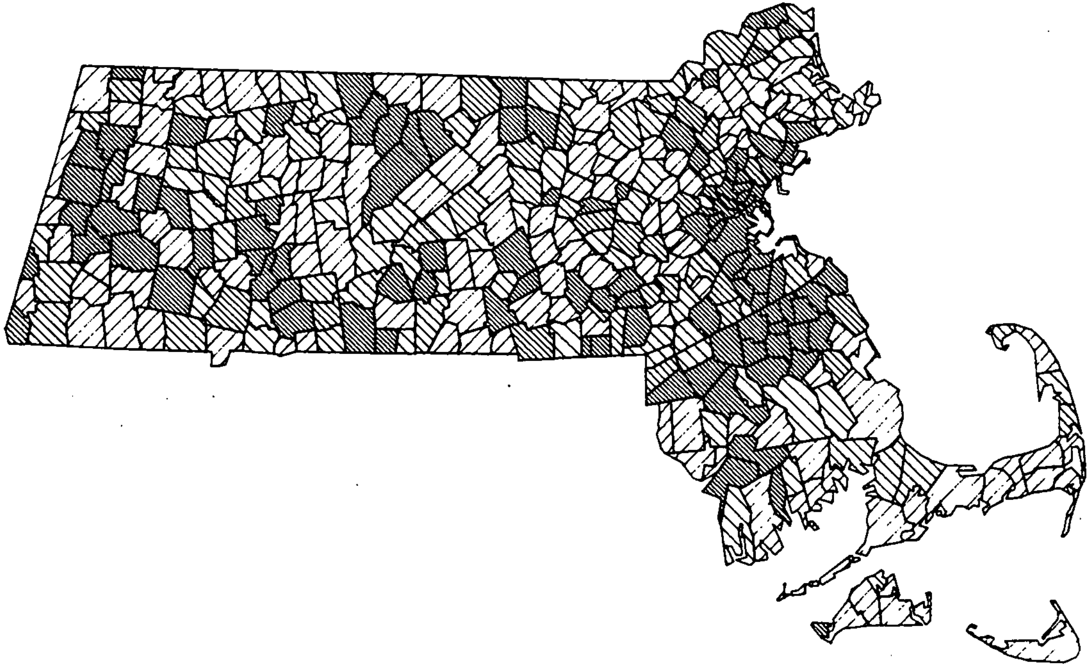


CHART 2

ANALYSIS OF FY 1982 IMPACTS OF PROPOSITION 2 1/2 IN MASSACHUSETTS
AFTER DISTRIBUTION OF 242M OF 265M IN NEW LOCAL AID
NET LOCAL PROPERTY TAX LOSSES ARE SHOWN IN RED, GAINS IN GREEN
PREPARED BY MITRE

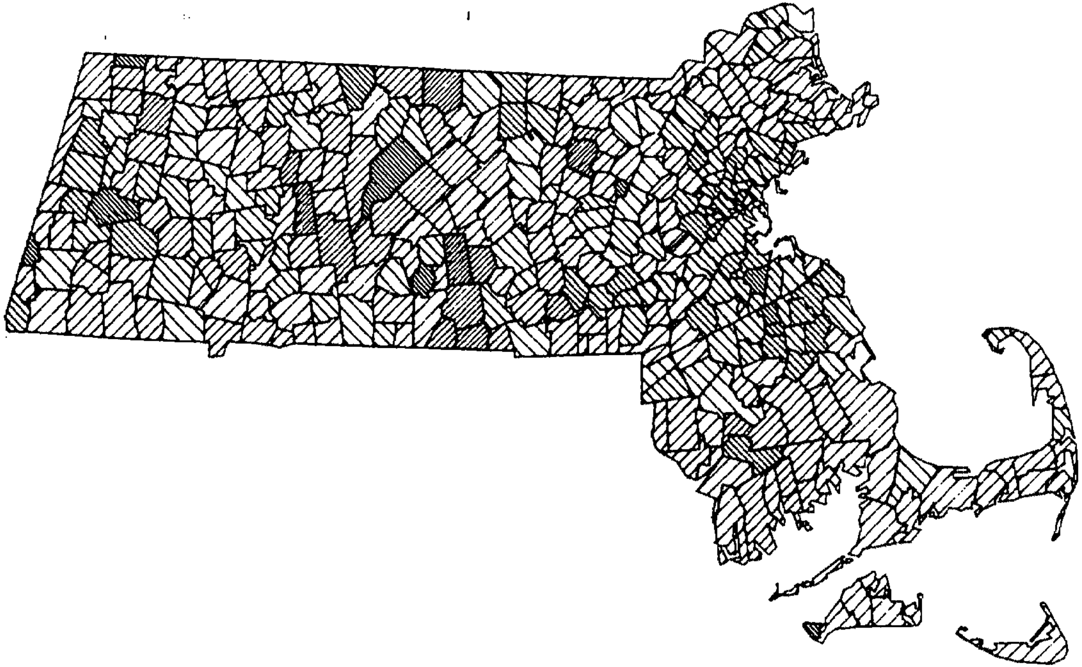
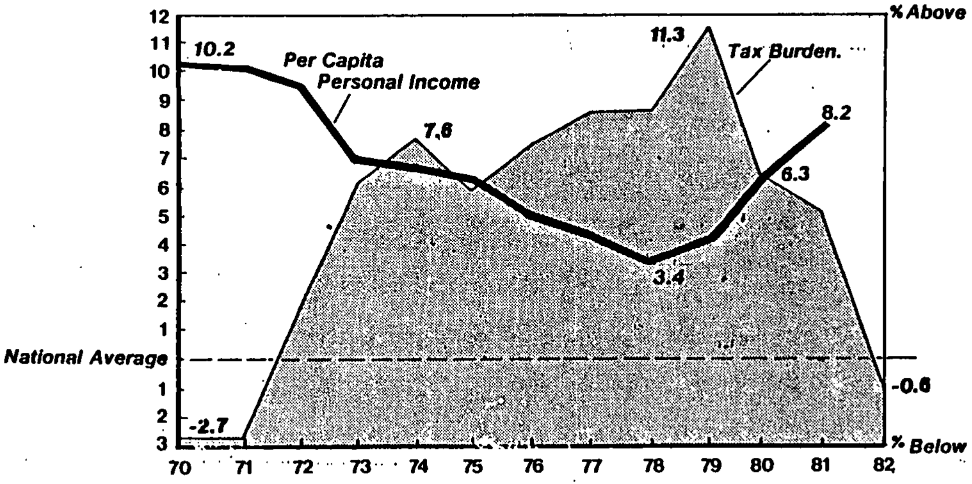


CHART 3

Massachusetts
Per Capita Personal Income & Total State & Local Tax Burden Compared to National Average



Tax Burden: Total St. & L Revenues as % of Total Personal Income

Source U.S. Dept. of Commerce

1981/82 Estimates by Associated Industries of Massachusetts

CHART 4

MASSACHUSETTS UNEMPLOYMENT FIGURES COMPARED TO THE NATIONAL AVERAGE

YEAR	STATE	NATIONAL
1969	3.9%	3.5%
1970	4.6	4.9
1971	6.6	5.9
1972	6.4	5.6
1973	6.7	4.9
1974	7.2	5.6
1975	11.2	8.5
1976	9.5	7.7
1977	8.1	7.0
1978	6.1	6.0
1979	5.5	5.8
1980	5.6	7.1
1981	6.4	7.6

Source: The Massachusetts Division of Employment Security.
Bureau of Census, U.S. Department of Commerce.

CHART 5

MASSACHUSETTS PERCENT CHANGE IN PER CAPITA INCOME COMPARED TO NATIONAL AVERAGE

Solid line state
Dotted line U.S. National Average

YEAR	MASSACHUSETTS		U.S.	
1968	$ 3,711		$3,401	
		9.75%		9.2 %
1969	$ 4,073		$3,714	
		6.77		6.2
1970	$ 4,349		$3,945	
		5.56		5.6
1971	$ 4,591		$4,167	
		7.73		8.35
1972	$ 4,946		$4,515	
		8.45		10.9
1973	$ 5,364		$5,010	
		8.42		8.74
1974	$ 5,816		$5,448	
		6.82		7.28
1975	$ 6,213		$5,845	
		7.79		9.0
1976	$ 6,697		$6,374	
		8.75		9.49
1977	$ 7,283		$6,979	
		9.83		10.83
1978	$ 7,999		$7,735	
		12.48		11.6
1979	$ 8,998		$8,637	
		12.5		10.2
1980	$10,125		$9,521	
1981	Figures are not available until April.			

Source: Regional Economic Information System, Bureau of Economic Analysis, U.S. Department of Commerce

Exhibit 16

STRATEGY FOR ECONOMIC REVIVAL

Comparative Plant Operating Costs, Five States[1]

	Massachusetts	Utah	Oregon	North Carolina	South Carolina
Wages, Unemployment Tax, Workman's Compensation (Average Hourly Wage)	$650,300 ($3.02)	$668,600 ($3.12)	$763,300 ($3.53)	$680,900 ($3.21)	$684,500 ($3.22)
Local Property Taxes	(2) 74,200	27,440	46,200	17,640	32,634
Inventory Tax	520	EXEMPT	1,980	2,520	EXEMPT
Machinery	(2) 7,420	3,567	4,620	1,764	3,263
State Corporate Income Tax (Effective Rate)	(2) 20,405 (9.5%)	6,787 (3.0%)	17,238 (7.5%)	13,216 (6.0%)	13,216 (6.0%)
Electricity	59,020	31,320	18,760	29,321	(3) 44,643
Gas	7,452	3,351	6,893	5,589	(3) ----
Water	610	366	66	262	236
Sewerage	(4) 5,000	84	43	262	90
Operating Costs	$824,927	$741,515	$859,100	$751,474	$778,582
Savings vs. Mass.	---	83,412		73,453	46,345
Added Cost vs. Mass.	---		34,173		

Notes: (1) A Massachusetts based high technology company planned to expand manufacturing capacity and had narrowed the choices down to the five states shown in this exhibit. The analysis was done in September, 1976. The basic assumptions on which the analysis was based were the following: the facility would include land valued at $400,000 and a plant costing $1,000,000; machinery would cost $140,000; inventory would be valued at $200,000; the plant would employ 100 persons.

(2) A one-time 3% Investment Tax Credit on tangible property is allowed in Mass. NOT INCLUDED IN ABOVE FIGURES. Taking the real estate value and the machinery value, a tax credit of $46,200 would be allowed. This one-time credit would reduce first year operating costs of $824,927 by $46,200.

(3) Gas is not available to industries. Electric heat with heat pumps.

(4) 50,000. Cost to build and maintain septic system for 10 years

Exhibit 17

STRATEGY FOR ECONOMIC REVIVAL

Personal Local Taxes

(Family of Four Using Standard Itemized Deduction Form)

	Massachusetts	Utah	Oregon	N. Carolina			S. Carolina
	Southborough	Salt Lake City	Eugene	Greenville	Newbern	Wilson	Columbia
House Furnishings	EXEMPT	EXEMPT	EXEMPT	(1)$5,000	$5,000	$5,000	EXEMPT
Assessment Rate (2)	71%	20%	100%	75%	65%	90%	4%
Millage Rate	$53.00	$98.41	$32.86	$13.75	$15.20	$13.875	$221.70
Real Estate Tax (3)	$1,880	$984	$1,630	$591	$581	$697	$443
Intangible Tax On Stocks (4)	NONE	NONE	NONE	$250	$250	$250	NONE
State Income Tax	$888	$898	$750	$840	$840	$833	$687
Automobile Tax	$462	$138	$20 (5)	$72	$69	$87	$162
Total Taxes	$3,230	$2,020	$2,400	$1,753	$1,740	$1,867	$1,292

Assumptions: (6)

Income		$ 20,000.00
Stocks		$100,000.00
House		$ 50,000.00
Cars	1@	$5,000.00
	1@	$2,000.00
Contributions		$500.00
Interest Paid		$250.00

(1) 10% of the value of the house. Taxed as if the furniture were real estate.

(2) Rates vary for different areas. Also, rates and apportionments differ between county, city, school district and waste disposal tax.

(3) Market value of home $50,000. Furniture taxed at same rate in N. Carolina.

(4) In N. Carolina the Intangible Tax also applies to Money on Deposit and Accounts Receivable. Money on Deposit is taxed at 10¢ per $100.00. Accounts Receivable are taxed at 25¢ per $100.00. The tax is collected by the state and distributed for the use of local governments.

(5) $10.00 per car per year.

(6) Based on a professional employee at a salary of $20,000 (1976), with company stock that pays no dividends.

Massachusetts - New Hampshire Oil Price Comparison

Price differentials between Massachusetts and New Hampshire, as well as among the other New England states, are due primarily to higher wholesaler margins in lower volume, remote rural areas. Precise quantification of wholesale price averages is exceptionally difficult, as neither State has traditionally monitored this data. However, the New Hampshire retail averages presented below do demonstrate the additional transport costs for moving product from terminals to retail markets. New Hampshire's geographic location in relation to producing and refining areas ultimately results in slightly higher costs to the consumer.

Since many of the same majors and independent terminal operations serve Massachusetts and New Hampshire, company per-barrel acquisition costs have a minimum impact on price differentials. As OPEC's prices have traditionally controlled the oil prices of both non-OPEC and U.S. producers, average acquisition costs bear no significant relation to retail prices within a particular state. Purchasing and refining of crude on a national scale does not result in interstate price differentials; rather, it is the additional charges for such items as transportation and storage that account for different final prices for the same products.

#2 Oil - Average Retail Prices

	Massachusetts	New Hampshire
1975	No Energy Information Administration or State Records	
1976	" " " " " " "	
1977	$ .474/gallon	$ .474/gallon
1978	.502	.502
1979	.823	.729
1980	1.010	1.080
1981	1.247	1.260
Current	1.270	1.270

TOM LYONS

Associated Industries of Massachusetts

4005 Prudential Tower Boston, MA 02199

262-1180

NEWS RELEASE

Although local politics and national economic issues sometimes cloud the public perception, the King Administration, in cooperation with the State legislature, is presiding over an unprecedented turnaround of the Massachusetts economy, according to the chief economist of Associated Industries of Massachusetts.

K. Heinz Muehlmann, writing in the association's monthly magazine "Industry", says the turnaround not only sharply reversed most unfavorable trends of the eight years before the governor took office, but has also re-established Massachusetts as one of the leading states in the nation.

He claims Massachusetts citizens seem unable to differentiate between the effects of state and national economic conditions, both of which not only impact their present economic well-being, but also their expectations for the future.

"While it can be safely said that the state's economy has performed exceptionally well relative to other states, the national economic problems of high inflation and two successive recessions have at the same time substantially overshadowed our overall economic success.

"Buoyed by a fast-growing high-technology sector, our economy survived the 1980 recession without any noticeable impact, but is suffering today under the strains of yet another national economic downturn" according to Muehlmann.

"While almost 30 states have passed tax increases to cover growing deficits, Massachusetts not only lowered its taxes substantially but is expected to generate a modest surplus. Not bad for a state which not so long ago was plagued by perennial deficits and unemployment rates 20 to 30 percent above the national level", Muehlmann comments.

Industry Magazine Story - 2

Three years ago Muehlmann detailed these problem areas for the state's policy leaders: 1. per capita personal income; 2. cost of living, and 3. the share of state and local taxes extracted from personal income.

He claims that the economy has performed conspicuously well in all three areas.

The steady decline of Massachusetts per capita income has reversed itself abruptly and within three years recaptured 84 percent of its decline, adding almost $5 billion to the state economy and more than $600 million in added revenue per year, according to Muehlmann.

The gain in personal income growth coupled with a slowdown in property tax increases due to the Governor's and the legislature's compromise four percent tax cap, resulted in lower housing costs and in turn reduced the overall cost of living index for the first time in many years, Muehlmann states.

In the third area -- the state tax share of income -- Muehlmann describes the administration's program as especially productive over the last three years with declines of 17 percent in state and local revenue burden (including fees), 20 percent in state and local tax burden (without fees), and 33 percent in property tax burden.

While upbeat on the results of economic progress in the state during the past three years, Muehlmann describes the outlook for our state economy as clouded with factors not of our own making.

"This year will be the year of Reaganomics when supply-side economics will be facing their crucial test. Massachusetts is well-positioned to partake in a national economic recovery. Its industries are healthie and its government is leaner than in the recent past and increases in defense spending will add to the prospects of a full recovery", according to the A.I.M. economist.

2/18/82

---AIM---

Representative REUSS. Thank you, Governor King.
Govenor Lamm.

STATEMENT OF HON. RICHARD D. LAMM, GOVERNOR, STATE OF COLORADO

Governor LAMM. Mr. Chairman, I would like to just briefly summarize some of my points and leave adequate time for questions.

I think, first, it's important for this committee to understand that in perhaps all of the Governors' minds the question of the budget cuts in fiscal 1983 cannot be differentiated from federalism. They are interrelated.

This New Federalism of 1984 takes off on the 1983 budgets; they are two wheels of the same cart; that they are interrelated and could be separated perhaps, but we definitely see them at this point as very important dual subjects that are related.

Point two is, there really is strong support among a bipartisan group of Governors for the New Federalism. There is among mayors, county commissioners, city council people, and certainly Governors of both parties a feeling that these very strong resolutions that various groups have passed have sometimes not been given adequate weight. The feeling is that there is an overextension, an overreaching on the part of the Federal Government and that perhaps the States can live without a Federal program on hypertension control or filling potholes.

We all have our own examples, but I think it's important for you to understand that, as Governor Matheson will say in a minute—this broad bipartisan support does exist.

Three, there's a certain skepticism on the part of a number of Governors that in fact the way New Federalism is coming down at us is more than a tax cut; perhaps it is a tax shift. The statement is made, and there is some evidence in that regard, that in California Governor Reagan didn't cut taxes as much as he shifted them. In fact, he shifted them to another level of government, to cities and counties. They had to raise their property taxes, resulting in proposition 13. That is given great weight among an awful lot of us because we see a number of these services that are coming down and that we are expected to fund are, in most instances, not eliminating the need for the service. What we are getting is simply the lack of Federal financing that shifts the burden to another branch of government. And I think that looms large in all of our considerations.

The fourth very brief point is that State and local tax bases are more regressive than the Federal system thereby imposing a greater tax burden on middle class and lower income families. We figure in Colorado, if $50 million of tax burden were shifted from the Federal base to the local base—for instance, for wastewater treatment needs, and so forth—that 82 percent of our households would pay more net taxes if that same amount of money has to be raised. I think, again, this is a point that we take very seriously.

Lastly, there's a feeling that it's the rate and pace of the transfer to other governments which becomes the big issue rather than what is transferred. You can't say to State and local governments all of a sudden, "here, catch," and throw us a large number of programs. It has to be a process. It has to be an approach where maybe we take a certain step at a time. You can't do it too fast because the rate and pace of the federalism could be as important as what programs are chosen; perhaps a 3- or 4-year program which allows us to evaluate how well it is going is much better than, all of the sudden, giving it back to us.

And last, the idea of national defense—we look and we read, for instance, in the latest Foreign Policy Association material—and I haven't checked these figures, I just quote them—that the Pentagon revealed between September and December of 1980 that the total purchase cost of 47 major weapon systems escalated from $362 billion to $410 billion. This represents more than the entire first round of budget cuts, $35 billion, achieved by the President in the 1982 domestic budget.

The States' plea is that the strength of our infrastructure, the strength of our bridges and roads, and also our very government system—is part of our national defense and one that can't be overlooked in this whole process.

Those are my comments. I will be pleased to respond to any questions.

[The prepared statement of Governor Lamm, together with attachments, follows:]

95-755 O—82——40

PREPARED STATEMENT OF HON. RICHARD D. LAMM

I APPRECIATE THE OPPORTUNITY TO TESTIFY BEFORE SUCH A DISTINGUISHED COMMITTEE AND TO BE A MEMBER OF SUCH A FINE PANEL. THE SUBJECT YOU ARE ADDRESSING IS ONE THE MOST IMPORTANT FACING OUR COUNTRY TODAY.

I WOULD LIKE TO ADDRESS TWO TOPICS THIS MORNING. THE FIRST IS HOW THE FEDERAL BUDGET CUTS HAVE AFFECTED COLORADO AND THE SECOND IS MY PERSPECTIVE ON NEW FEDERALISM.

FEDERAL BUDGET CUTS

IN THE FISCAL YEAR 1982 COLORADO LOST APPROXIMATELY $280 MILLION AS A RESULT OF THE FY 82 BUDGET CUTS, WITH STATE AND LOCAL GOVERNMENTS BEING REDUCED BY $207 MILLION OF THIS TOTAL. (THESE CUTS ARE OUTLINED BY MAJOR AREAS IN ATTACHMENT A.) BECAUSE OF OUR TIGHT FISCAL SITUATION, WE HAVE BEEN ABLE TO REPLACE ONLY $2 MILLION OF THESE LOSSES OR LESS THAN 1%. TO PUT THIS IN HUMAN TERMS LET ME DESCRIBE A FEW OF THE EFFECTS.

WE HAVE CLOSED 20 OF OUR 43 JOB SERVICE CENTERS RESULTING IN 15,000 FEWER JOB PLACEMENTS. 1700 CHILDREN

WHOSE MOTHERS ARE IN EDUCATIONAL PROGRAMS LOST DAY CARE SERVICES. 5000 HOUSEHOLDS ARE NO LONGER RECEIVING FOOD STAMPS AND 5400 CHILDREN ARE BEING DEPRIVED OF CHILD HEALTH SERVICES. (A FULL LIST OF THESE IS PRESENTED IN ATTACHMENT B) THE IRONY OF THIS SITUATION IS THAT AT A TIME WHEN WE WANT TO MOVE PEOPLE FROM WELFARE TO JOBS THE CUTS ARE HURTING THE WORKING POOR MORE THAN ANY OTHER GROUP. SIMILARLY, WHEN OUR NATION NEEDS TO FURTHER ECONOMIC GROWTH THROUGH INFRASTRUCTURE DEVEOPMENT WE FIND REDUCTIONS IN WASTE WATER TREATMENT.

MOST STATES HAVE LITTLE CAPACITY TO REPLACE SUCH CUTS. STATE SURPLUSES HAVE TRENDED DOWN. IN 1980 AVERAGE STATE SURPLUSES AS A PERCENTAGE OF THEIR OPERATING BUDGET WAS 9%. IN 1981 THIS FIGURE WAS 3.3%. THIS YEAR IT IS 1.5%. PUT ANOTHER WAY, THIS YEAR 30 STATES ARE NEAR BEING IN THE RED OR HAVE SURPLUSES OF LESS THAN 1%. THE STATES' COLLECTIVE FISCAL HEALTH IS ANEMIC. MORE FY 83 CUTS SERIOUSLY THREATEN THE WELLBEING OF THE STATE'S CAPACITY TO PROVIDE VITAL SERVICES. COLORADO'S PROJECTIONS FOR NEXT YEAR INDICATE WE COULDN'T REPLACE ANY LARGE PERCENTAGE OF THESE CUTS NEXT YEAR WITHOUT INCREASING LOCAL TAXES.

AT THIS POINT, I THINK IT'S IMPORTANT TO REFLECT ON WHAT'S REALLY HAPPENING IN THIS AREA. FEDERAL BUDGET CUTS DO NOT ELIMINATE THE NEED FOR SERVICES IN MOST INSTANCES--THE LACK OF FEDERAL FINANCING SHIFTS THE BURDEN TO ANOTHER BRANCH OF GOVERNMENT. WHEN RONALD REAGAN REDUCED THE STATE BUDGET AS GOVERNOR OF CALIFORNIA, HE MERELY TRANSFERRED

THE RESPONSIBILITY FOR MANY OF THE SERVICES TO THE LOCAL LEVEL. LOCAL TAXES (WHICH ARE MORE REGRESSIVE) HAD TO BE RAISED, AND THIS LED TO A PROPERTY TAX REVOLT CULMINATING IN PROPOSITION 13. REAGANOMICS IS NOT NECESSARILY AN OVERALL REDUCTION IN THE TAX BURDEN; IN MANY STATES IT MAY BE A SHIFT FROM THE FEDERAL TAX BASE TO STATE AND LOCAL TAX BASES.

UNFORTUNATELY, STATE AND LOCAL TAX BASES ARE MORE REGRESSIVE THAN THE FEDERAL SYSTEM THEREBY IMPOSSING A GREATER TAX BURDEN ON MIDDLE CLASS AND LOWER-INCOME FAMILIES. FOR EXAMPLE, IN COLORADO IF $50 MILLION OF TAX BURDEN WERE SHIFTED FROM THE FEDERAL BASE TO THE LOCAL BASE (I.E., FOR WASTE WATER TREATMENT NEEDS, ETC.), 82% OF OUR HOUSEHOLDS WOULD PAY MORE NET TAX (SEE ATTACHMENT C), THAT IS, ANY HOUSEHOLD EARNING $25,000 OR LESS PER YEAR.

BROADER PERSPECTIVE

IT MIGHT BE USEFUL TO LOOK AT REAGANOMICS FROM A BROADER PERSPECTIVE. HISTORICALLY, FEW ADMINISTRATIONS IN OUR HISTORY HAVE MADE RADICAL CHANGES IN THE MANNER IN WHICH THE COUNTRY WAS DOING BUSINESS. CERTAINLY, ANDREW JACKSON, ABRAHAM LINCOLN AND FRANKLIN ROOSEVELT MADE SUCH LARGE CHANGES AND ALL THREE IMPROVED OUR NATION, THE MANNER IN WHICH WE ARE GOVERNED AND THE QUALITY OF LIFE OF OUR CITIZENRY. IT'S CLEAR FROM HIS FIRST YEAR IN OFFICE THAT RONALD REAGAN IS ATTEMPTING TO RADICALLY ALTER THE FEDERAL ROLE THAT HAS BEEN ESTABLISHED ON A BI-PARTISAN BASIS OVER THE PAST 50 YEARS.

INSTEAD OF TRYING TO IMPROVE THE INTERGOVERNMENTAL RELATIONSHIP HE'S MAKING IT A ONE WAY STREET. THE GOVERNORS

ARE TRYING TO DECENTRALIZE AND DECONGEST THE GRANT-IN-AID SYSTEM. THE PRESIDENT IS TRYING TO SOLVE HIS BUDGET PROBLEM AND ELIMINATE THE FEDERAL DOMESTIC ROLE AT THE STATE'S EXPENSE. WE WANT BALANCED FEDERALISM, HE'S PROPOSED NO FEDERALISM.

WHAT MR. REAGAN APPEARS TO BE DOING IS TO EITHER ELIMINATE OR TO SEVERELY CURTAIL THE FEDERAL FINANCING OF A NUMBER OF IMPORTANT DOMESTIC EFFORTS THAT HAVE ENHANCED THE QUALITY OF LIFE FOR MOST AMERICANS SINCE THE GREAT DEPRESSION. OVER THE PAST HALF CENTURY, OUR NATIONAL GOVERNMENT HAS CHOSEN TO PROTECT OUR ENVIRONMENT, MAINTAIN AND IMPROVE OUR CAPITAL INFRASTRUCTURE IN ORDER TO KEEP PACE WITH ECONOMIC GROWTH, IMPROVE THE HEALTH AND NUTRITION OF OUR CITIZENS, AND TO INSURE THAT ALL AMERICANS, REGARDLESS OF CIRCUMSTANCES, CAN HAVE THE BASIC NECESSITIES OF FOOD, SHELTER AND CLOTHING.

THIS IS NOT TO SAY THAT THE FEDERAL GOVERNMENT HASN'T GONE BEYOND APPROPRIATE BOUNDS. IT HAS. MOREOVER, THE STATES SHOULD HAVE MORE OF THE RESPONSIBILITY FOR MANY OF THE ACTIVITIES CURRENTLY CONTROLLED OUT OF WASHINGTON.

NEW FEDERALISM

THE CONGRESS IS DEBATING SEVERAL MAJOR ISSUES. WE ARE PLAGUED WITH HIGH UNEMPLOYMENT, EXHORBITANT INTEREST RATES, MASSIVE DEFICITS AND TRAGIC SOCIAL INEQUITIES.

OVERCENTRALIZATION OF GOVERNMENT IS A LESS DRAMATIC BUT NO LESS SERIOUS INFIRMITY OF OUR SOCIETY. NOT EVERY SOCIAL AND ECONOMIC PROBLEM IS OF THE MAGNITUDE THAT DESERVES A FEDERAL INITIATIVE. BY THE SAME TOKEN NEW

FEDERALISM SHOULD NOT BE A CODE WORD FOR TOTAL FEDERAL WITHDRAWAL FROM LEGITIMATE DOMESTIC ACTIVITY. THE GOVERNORS' OBJECTIVE IN NEGOTIATING WITH THE ADMINISTRATION AND CONGRESS ON SOME CORRECT FORM OF NEW FEDERALISM IS TO RESTORE BALANCE IN PURPOSE AMONG THE LEVELS OF GOVERNMENT WITHOUT FY 83 BUDGET CUTS.

WE NEEDED THE CENTRALIZATION THAT ROOSEVELT BROUGHT IN THE 1930'S TO CLIMB OUT OF A DEPRESSION. SINCE THEN WE'VE MOVED TOO FAR AND THE 1980'S REQUIRE BALANCE.

WE HAVE A NATIONAL GOVERNMENT WHICH IN ADDITION TO ITS APPROPRIATE ROLE OF SETTING NATIONAL GOALS AND USING ITS EFFICIENT AND PROGRESSIVE REVENUE GENERATING CAPABILITIES TO MEET NATIONAL GOALS, HAS BECOME INAPPROPRIATELY INVOLVED IN DETAILS OF ADMINISTERING PROGRAMS AT STATE AND LOCAL LEVELS. WE NOW HAVE STATES WHICH ARE SUBSTANTIALLY REFORMED IN STRUCTURE AND FISCAL CAPACITY AND THIS NEEDS TO BE RECOGNIZIED.

THE GOVERNORS' HAVE ADOPTED ON A BIPARTISAN BASIS A WORKABLE FEDERALISM PROPOSAL.

1. FOOD STAMPS, AFDC, AND HIGHWAY PROGRAMS SHOULD REMAIN AS FEDERAL PROGRAMS WITH HIGHWAY AND AFDC COSTS BEING SHARED BY THE STATES.
2. MEDICAID SHOULD BECOME A FULLY FEDERALIZED PROGRAM THUS LOCATING HEALTH CARE DELIVERY IN ONE SPOT AND THEREBY IMPROVING ACCOUNTABILITY AND OPPORTUNITY FOR COST EFFECTIVENESS. FEDERAL COST - $19 BILLION IN 1984 INCLUDING OPTIONAL SERVICES.
3. THE STATES WOULD NEGOTIATE TAKEOVER OF A PORTION OF THE $31 BILLION OF CATEGORICAL PROGRAMS IN ORDER

TO MAKE THE MEDICAID SWAP AN EVEN ONE. IN MY VIEW THIS REQUIRES CAREFUL EVALUATION OF FEDERAL PURPOSE. SOME PROGRAMS SUCH AS CHILD NUTRITION AND HUMAN CAPITAL INVESTMENT MIGHT BE APPROPRIATE FEDERAL FINANCIAL RESPONSIBILITIES. OTHERS SUCH AS LIBRARIES AND HYPERTENSION CONTROL AND ALCOHOL TREATMENT COULD BE LOCAL DECISIONS.

4. TO RELIEVE FISICAL INEQUITIES THE STATES SHOULD HAVE AVAILABLE A RELIABLE PERMANENT TRUST, PERHAPS AS SUGGESTED BY SEN. DURENBERGER.
5. FURTHER GRANT-IN-AID BUDGET CUTS ARE HARMFUL TO THIS PROPOSAL.

CONCLUSION

I BELIEVE THAT THIS PROGRAM IS BALANCED AND A MAJOR STEP TOWARD GRANT-IN-AID REFORM. IN HIS INAUGURAL ADDRESS THE PRESIDENT DECLARED THAT OUR CITIZENS' PROBLEM IS THEIR GOVERNMENT. WHILE HE CORRECTLY PERCEIVED PEOPLE'S ANGER AT GOVERNMENTAL INEFFICIENCY AND CONFUSED ACCOUNTABILITY, HE MISPRESCRIBED THE SOLUTION. PEOPLE WANT GOVERNMENT TO WORK FOR THEM, NOT ABANDON THEM. THE GOVERNOR'S VIEW ON NEW FEDERALISM EMBODIES THESE NEEDED CHANGES. I RESPECTFULLY COMMEND THE NGA PROPOSAL TO YOU FOR ACTION.

ATTACHMENT A

FEDERAL BUDGET REDUCTIONS

Federal budget reductions are expected to have a major impact on programs in Colorado. Based on the 1981 Omnibus Budget Reconciliation Act, the total impact to Colorado programs is estimated at between $250 and $270 million in state fiscal year 81-82. Of that amount, the impact to state and local programs is estimated at approximately $195 million. A summary of these reductions is presented below in the first column. In addition, recent Federal action reduced most nonentitlement programs by an additional 4 percent in federal fiscal year 1981-82. These actions are expected to result in a total reduction to Colorado programs of approximately $200 million in state fiscal year 1981-82. (See the second column below.)

In 1982-83, the effect of the 1981 Reconciliation Act and additional four percent reductions will be greater since reductions will be effective for a full twelve month period. Moreover, double-funding of block and categorical grants will be eliminated, and forward-funded programs, such as education, will experience the primary impact. These reductions are estimated below in the third column. In addition, substantial new reductions are anticipated in the 1982-83 Federal budget. In anticipation of these further reductions, the Executive budget provides resources to replace $2.3 million in Social Services (Title XX) programs and $0.7 million in Health Services programs. As the scope and magnitude of 1982-83 federal budget reductions become known, additional reductions are anticipated. In order to provide projected effects for 1982-83, Column 4 assumes an additional 15 percent across-the-board cut from the projected 1982-83 funding.

($ in Thousands)

Long Bill Programs:	1981-82 (Reductions)/ Increases based on 1981 Reconcilliation Act	1981-82 (Reductions)/ Increases Based on 1981 Reconcilliation Act + Additional 4%	Additional 82-83 (Reductions)/ Increases Based on 1981-82 Actions	Additional 82-83 (Reductions)/ Increases Based on 1981-82 Actions + Additional 15%
Education				
- USDA School Lunch Program	(4,584)	(4,584)	-0-	(3,477)
- Elem. & Secondary Ed. (Title I)	(139)	(139)	(1,493)	(5,576)
- Elem. & Secondary Ed. (Block Grant)	N/A	N/A	(46)	(783)
- Handicapped Education	-0-	(403	(12)	(1,512)
- Other Programs	(1,459)	(1,527)	974	813
Subtotal	(6,182)	(6,653)	(577)	(10,535)
- Energy Conservation	(354)	(385)	(424)	(470)

Long Bill Programs:	1981-82 (Reductions) /Increases based on 1981 Reconcilliation Act	1981-82 (Reductions)/ Increases Based on 1981 Reconcilliation Act + Additional 4%	Additional 82-83 (Reductions)/ Increases Based on 1981-82 Actions	Additional 82-83 (Reductions)/ Increases Based on 1981-82 Actions + Additional 15%
Health				
- Environmental Protection	146	146	(724)	(1,170)
- Health Protection	224	224	(1,318)	(1,476)
- Mental Health	(1,301)	(1,536)	366	(342)
- Alcohol and Drug Abuse	244	(70)	969	(361)
- Health Care Services and Other Programs	(3,104)	(3,727)	150	(2,776)
Subtotal	(3,791)	(4,963)	(557)	(6,125)
Higher Education				
- Vocational Education	(5,266)	(5,685)	763	(876)
- Arts and Humanities	-0-	(22)	(145)	(202)
- Other Higher Education Programs	(10,296)*	(10,311) *	6,130	80
Subtotal	(15,562)	(16,018)	6,748	(998)
Highways	(2,020)	(2,020)	43	(173)
Institutions	(346)	(358)	(350)	(579)
Law	(29)	(29)	(60)	(60)
Local Affairs	(956)	(1,087)	(2,113)	(2,338)
Natural Resources	(249)	(249)	(895)	(1,371)
Personnel	(196)	(196)	(66)	(66)
Regulatory Agencies	-0-	(25)	(414)	(478)

Long Bill Programs:	1981-82 (Reductions) /Increases based on 1981 Reconcilliation Act	1981-82 (Reductions)/ Increases Based on 1981 Reconcilliation Act + Additional 4%	Additional 82-83 (Reductions)/ Increases Based on 1981-82 Actions	Additional 82-83 (Reductions)/ Increases Based o 1981-82 Actions + Additional 15%
Social Services				
- Title XX	(5,891)	(5,891)	-0-	(4,566)
- Aid to Families with Dependent Children	(3,736)	(3,736)	(540)	(6,869)
- Medicaid	(1,994)	(1,994)	(3,006)	(17,856)
- Denver Income Maintenance Experiment	(1,039)	(1,039)	-0-	-0-
- Rehabilitation Services	(2,056)	(2,350)	(881)	(1,366)
- Low Income Energy Assistance	-0-	(841)	-0-	(4,104)
Subtotal	(14,716)	(15,851)	(4,427)	(34,761)
TOTAL LONG BILL PROGRAMS	(44,401)	(47,834)	(3,092)	(57,954)
Off Budget Programs:				
- Higher Education Sponsored Research	(4,033)	(4,033)	3,495	3,495
- Highway Construction	(13,551)	(13,551)	5,611	(16,889)
- Labor and Employment	(9,685)	(14,196	-0-	(5,227)
- Food Stamps	(13,500)	(13,500)	(4,500)	(14,500)
- Student Loans	(21,500)	(21,500)	Unknown	Unknown
- Subtotal	(62,269)	(66,780)	4,606	(33,121)
TOTAL STATE PROGRAMS	$(106,670)	$(114,614)	$ 1,514	$(91,075)
Local Government Programs **	(88,928)	(88,928)	(39,301)	(39,301)
TOTAL STATE WIDE REDUCTIONS	(195,598)	(203,542)	(37,787)	(130,376)

* Includes $9.1 million overestimation of federal funds in the 1981-82 Long Bill for the Unversity Health Sciences Center.
** See the issue paper on Strenthening Local Government for futher information on impact to local governments.

ATTACHMENT B.

EFFECTS OF REAGAN CUTS ON SERVICES IN COLORADO

Program Area	Reduction in Services
Health:	
Maternal and Child Health	5,400 children
Handicapped Children	1,300 children
Family Planning	214 clients
Community Nursing	20 clinic days 2,000 children
Migrant Health	500 clients
Disease Control and Epidemiology	5,700 clients
Social Services:	
AFDC	2,576 households
Medicaid	2,576 households
Food Stamps	5,000 households
Day Care	1,667 children (approx. 4,000 were it not for refinancing)
Voc Rehab	2,274 clients
Medicaid	2% reduction in Federal participation
Labor and Employment:	20,000 fewer client placements 30 Job Service Centers 3,250 CETA PSE jobs eliminated

ATTACHMENT C

REGRESSIVITY OF REPLACING FEDERAL FUNDING WITH STATE AND/OR LOCAL FUNDING

Colorado data for calendar 1979 demonstrates the regressivity of state and local taxes compared with the progressivity of federal income taxes. The table below uses the Colorado data to demonstrate the impact of switching $50 million from federal income taxes to state or local taxes and to just local taxes for households at various income levels. Adjustments would be required to obtain more accurate figures for the current year, but the basic trends would be the same. The switch from federal to state and local is clearly regressive, and if switched only to local, it is more so.

Change in Taxes if $50,000,000 Switched from Federal to State and Local and to Local Only

(Based on 1979 Colorado income levels)

Household Income Range	Under $5,000	$5,000-15,000	$15,000-25,000	$25,000-50,000	Over $50,000
Ave. Household Income	$4,669	$12,195	$21,845	$36,164	$96,047
Number Households	342,783	410,121	251,610	195,069	29,695
Federal Income Tax Reduction/Household	-$1	-$15	-$44	-$95	-$462
If Replaced by State & Local Taxes					
State & Local Tax Increase/Household	+$15	+$31	+$51	+$74	+$164
Net Change/Household	+$14	+$16	+$7	-$21	-$298
		82% of Households		18% of Households	
If Replaced by Local Taxes Only					
Local Tax Increase/Household	+$18	+$34	+$51	+$70	+$122
Net Change/Household	+$17	+$18	+$7	-$25	-$340
		82% of Households		18% of Households	

Sources: Colorado Tax Profile Study 1980, Zubrow, et.al.(1981)
Office of Tax Analysis, Secretary of the Treasury (1980)

Representative REUSS. Thank you very much, Governor Lamm. Governor Matheson.

STATEMENT OF HON. SCOTT M. MATHESON, GOVERNOR, STATE OF UTAH

Governor MATHESON. Thank you. Mr. Chairman and members of the Joint Economic Committee, I'd like to commend this committee for initiating the dialog with State and local officials on the New Federalism and particularly as it relates to the 1983 budget.

I would like to submit for the record two recent National Governors' Association publications which summarize much of what my statement contains today.

Representative REUSS. Without objection, they will be received.

Governor MATHESON. I would like to simply summarize two or three points so we can get into some discussion.

I think we need to put into perspective as we look at the budget and the New Federalism, both of which will undoubtedly take a great deal of time of the Congress this year, the current fiscal condition of the States who are a beneficiary or a loser depending upon how public policy is settled at this level.

The governors have developed a set of principles and policies to unite our individual efforts, but with revenues buffetted by the recession, a majority of States entered this year are either projecting deficits or teetering on the brink of a deficit. Most States can't have those. Our constitutions say we must balance the budget every year.

The studies we have looked at indicated that in the past the average State tried to end up with about a 5-percent surplus, but the NCSL has just completed an interesting survey and 30 States will conclude their current fiscal years either in the red or below 1 percent. Those States are all across the country, not just in some of the regions.

Interestingly enough, in the legislative session this year during 1981, with the effort to put together austere 1982 budgets, more than half of the States ended up raising their taxes.

I think the bottom line really is this: The fiscal year 1982 budget may have been a banner year from some perspective in Washington, but I can tell you that for the States, the major cuts came with very minor flexibility.

Of the $7.8 billion in noneducation block grants, only $2.3 had any real flexibility in them at all. In the budget this year we hope that in the deliberations of the Congress it will not repeat the block grant scenario of 1982. Joe Brennan put it well, addressing a group of Senators not too long ago, "You've got to begin to trust us. We can and we have the capability to carry out the administration of programs with skills and efficiencies."

I think the average State capability in the last 10 years has come up dramatically and I think Joe Brennan's comment has some relevancy.

I have just a comment or two about federalism, Mr. Chairman. Under the administration's plan, the 1983 budget reductions are recommended to be put in place before we enter into our new partnership of federalism in 1984. We had felt that our proposal for

1982 was a fair one. We suggested that we would be willing to take 10 percent less with more flexibility along with the programs and we could administer those programs sufficiently at a level of efficiency so that the 10 percent would not be difficult to absorb.

Unfortunately, we received an over-20-percent cut and very little flexibility. We now see the 1983 budget proposals from the administration and it appears from our analysis that the States would be about a $9.1 billion loser as we go into the 1984 fiscal year if the Congress adopts the turnback programs recommended by the President.

The New Federalism is a major concern and a major interest to Governors. We concluded yesterday 3 days of intensive debate and discussion on what position we should take on the issue of New Federalism. It is not a new subject for Governors. We have debated it and supported it for years and NGA's positions on policy are well known.

We proposed last year basically that the Federal Government involve itself in the funding of the incomes security cut programs and that the States have turned over to them the type of categorical program that historically and practically and efficiently the States could manage, and work it out so we didn't have a shift in budget but we balanced the Federal system. That's the theory upon which the States basically operated.

The President has submitted his state of the Union New Federalism proposal in which he has recommended federalized medicaid and he has suggested as a swap that the States take AFDC and food stamps. That has been the basic debate in the last 3 days among the Governors. But we concluded our plenary session yesterday by adopting a proposal that the medicaid be federalized but that we not involve AFDC and food stamps at this time. Some Governors want to talk about it. Some Governors want to leave it as it is. And we reached the point where we couldn't get any consensus and we set it aside. I happened to be with the set-aside group, but we did not take a formal position.

What that means is this. If the Federal Government were to federalize medicaid, the States would take the savings which they put into the program now, add a trust fund, and then select from the programs which legitimately could be returned to the States on a case-by-case basis so that the dollars are evened out and we end up in 1984 going into a pretty major step forward in New Federalism. It's about as much I think as we can digest and probably even more in 1 year's time, and to me it's a major step forward to go to that point. We have provided means for the disparity of welfare in States, which is a major program, and I do believe our proposal is one which the President is now taking another look at and we have appointed or will appoint a small negotiating team of Governors and meet with the administration to see how that works out.

One of the things that I should tuck in at this point, Mr. Chairman, whatever happens in the New Federalism, it will have to involve the third partner in the process; and that is the Congress. We will be discussing those matters thoroughly with the Members of the House and the Senate in the days ahead.

We have made some specific recommendations on the 1983 budget proposals. We have urged through our executive committee at the NGA that we have level funding for our State and local nonentitlement programs for 1983 and 1984. In other words, we oppose the President's recommendation to cut that by $5.9 billion. We also proposed through that committee that if discretionary programs were to be cut, the reductions should be balanced with comparable increases in the Federal share of incomes security programs. The proposal from the President is a cut in those programs of $3.9 billion.

The executive committee also called for greater scrutiny of our defense budget and the tax expenditures so that evenhanded treatment is meted out to all on a fair basis. In other words, I think the Governors said nobody gets a blank check on anything any more and we have to take a look at each of the portions of the budget and see what is fair and equitable.

Finally, the block grants. We think last year was a major disaster for the States. We ended up with the block grants with massive cuts in the dollars and very little flexibility to be more efficient with them. As a consequence, in my own State, we reduced our Federal program funds by about $50 million and absorbed that into our program by, first of all, cutting administration as far as we could, but there's a big gap. If we have to take jolt number two this year on those programs, I do not believe that many of the basic essential programs in health and social services can basically make it, and I hope we would go into our New Federalism in 1984, if we do so, with a healthy State partner and not an anemic one.

Thank you, Mr. Chairman.

[The prepared statement of Governor Matheson, together with attachments and two papers referred to for the hearing record, follows:]

Prepared Statement of Hon. Scott M. Matheson

Mr. Chairman and Members of the Joint Economic Committee. I commend you for initiating the Congressional dialogue with state and local officials concerning the New Federalism and the FY 83 budget proposals.

The Joint Economic Committee has an excellent record of highlighting the impact of federal decisions on state and local governments. It was in cooperation with this committee that the National Governors' Association began its initial — and now annual — fiscal survey of states. This committee's excellent work on local financial issues is well known.

Today I would like to make several summary statements on the current fiscal condition of the states, the New Federalism proposals, and the FY 1983 budget proposals and to conclude with comments about what the governors will be talking to Congress about in 1982. Mr. Chairman, I would like to submit for the record two recent NGA publications which summarize much of what I will say today: "The President's Federalism Initiative" and "The Proposed FY 1983 Federal Budget: Impact on the States."

Our concerns about federalism in general, and FY 1983 in particular, spring from the current fiscal condition of the states. On this basis, the governors have developed a set of principles and policy that unite our individual efforts. With their revenues buffeted by the national recession, the majority of states entered 1982 either projecting deficits or teetering on the brink of deficit. Since states cannot legally have deficits, this means tax increases or large service cuts on top of a depressed economy. In the past, a year-end balance equal to five percent of annual spending was considered a prudent cushion. According to a recent survey, 30 states expect to conclude their current fiscal years in the red or with a balance below one percent.

These states are in all parts of the country:

<u>New England</u> Connecticut, Massachusetts, New Hampshire, Rhode Island, Vermont

<u>Middle Atlantic</u> New Jersey, New York, Pennsylvania

Great Lakes	Indiana, Michigan, Ohio, Wisconsin
Plains	Minnesota
Southeast	Alabama, Arkansas, Florida, Georgia, Kentucky, Mississippi, North Carolina, South Carolina, West Virginia
Southwest	Arizona
Rocky Mountain	Colorado, Idaho, Utah
Far West	California, Oregon, Washington

Nine other states forecast balances of one to five percent, and only seven predict surpluses of more than ten percent. Most of the states with large balances derive substantial revenue from their energy industries.

Although more than half the states raised taxes during 1981 legislative sessions, state budgets in 1982 are austere, suffering from sluggish revenue growth and increased recession related expenses. States are also finding that actual revenue is falling short of projections: 21 states indicated that revenue was below official forecasts, while only 10 indicated it exceeded the forecast. Since the recession worsened significantly after October, when this information was collected, the situation appears even more tenuous today. For example, Wisconsin originally responded to the survey saying it expected a surplus of more than $53 million. But in late January, legislative and executive estimates of the deficit for the current biennium ranged from $377 million to $450 million.

Fiscal hard times are already upon most states, before additional adverse impacts due to federal decisions are even considered. The FY 1983 budget proposals and unanswered aspects of the New Federalism proposal would weaken our capacity to meet the needs of our citizens directly and indirectly through our local governments.

Please remember the FY 1982 federal budget was a banner year, but only one way – your way – ending in major cuts and minor flexibility. Of the $7.8 billion in non-education block grants, only $2.3 billion was provided with some flexibility to target the funds where they were most needed. This $2.3 billion exactly equals the lost revenue

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sharing for states in 1982 and it also equals the estimated 1982 lost revenues to states due to the new corporate depreciation schedules and "All Savers" certificates. Please do not repeat this block grant scenario for the governors in FY 1983. Block grants are crucial to any reasonable restructuring of federal assistance but not with drastic cuts in funding and little or no flexibility. Congress must learn to trust state and local governments — or the people will lose trust in Congress.

The President's Federalism Initiative

For a decade, the governors have pleaded with presidents and Members of Congress to adopt a set of principles to guide changes in the federal systems. The major principles are:

a. federal assumption of income maintenance programs with reasonable benefit levels,
b. protection of civil rights,
c. block grants rather than categorical grants,
d. stability and predictability in funding levels,
e. lead time for adequate transition,
f. reliance on the same laws and procedures for the expenditure of federal funds which a state uses for its own funds,
g. equity in state by state impact.

All of these principles are included, at least in part, in the President's federalism initiative. The governors applaud the President for his initiative. We intend to negotiate with the President and the Congress in good faith. We urge the Congress to seriously weigh all proposals in light of the principles I have listed.

The NGA paper on this subject of February 5, 1982, summarizes the governors' major concerns with the New Federalism proposals. The five most critical issues at this time are:

- the exact nature of the federalized medical assistance program;
- the need for a continued federal role in other income security programs;
- the exact nature of maintenance of effort requirements to be placed on states for income maintenance in AFDC and food stamps;
- the equity and duration of the resource turnback element of the federalism proposal; and
- the need to define a continuing federal role in financing the nation's basic infrastructure.

Under the Administration's plan, the FY 1983 budget reductions are a step along the road to the transfer of federal responsibilities for programs now financed by grants. For this reason, the governors cannot separate the federalism initiative from the FY 1983 budget proposals. FY 1983 becomes the new base year in terms of dollars for the New Federalism. Our analysis shows that the states would be a $9.1 billion loser in FY 1984 for the turnback programs. This includes a proposed reduction of over $5 billion in the turnback programs themselves and almost $4 billion in food stamps and AFDC cuts. As a result, OMB estimates a <u>decrease</u> in combined AFDC and food stamp costs of 10.7 percent over the next three years while CBO shows an <u>increase</u> for the same programs and time period of 12.2 percent. All of these changes would have to be authorized by Congress in FY 1983 to become effective in FY 1984. The governors strongly object to many of these cuts. The President acknowledges we differ on cuts for FY 1983 and expects the governors to pursue their views with Congress.

<u>FY 83 Budget Proposals</u>

The governors submitted their views on the FY 1983 budget directly to the President on December 4, 1981. Mr. Chairman, I have attached a copy for the record of this letter to the President. Also attached is our February 13, 1982 analysis of the FY 1983 proposed budget.

In summary, the FY 1983 proposed budget falls short on four important points which the NGA's Executive Committee endorsed in the December 4 letter to the President:

- the Executive Committee urged level funding of state and local "non-entitlement" programs in fiscal 1983 and 1984; the administration's budget cuts such programs by $5.9 billion;
- the Executive Committee proposed that if discretionary programs were to be cut, the reductions be balanced with comparable increases in the federal share of welfare, Medicaid, and other income security programs. The administration's budget cuts these state-administered income security programs by $3.9 billion, including changes that reduce the federal government's current share of all these programs.
- the Executive Committee called for greater scrutiny of defense spending and tax expenditures and for even-handed treatment of direct federal entitlement programs, many of which are not based on need, and state-federal entitlements, where need is always a factor. The proposed budget increases defense by 18 percent, proposes modest tax revisions, and cuts direct federal entitlements by 2.2 percent and state-federal entitlements by 11.7 percent.
- the Executive Committee called for increased attention to capital infrastructure needs. The proposed budget provides $2.4 billion for wastewater treatment plants in both fiscal 1982 and 1983 but continues to delay and stretch out other capital infrastructure spending, including highways, rail systems, and airports.

Importance of Grants in State-Local Finance

The attached table I shows the relative importance of grant programs in the context of state and local finance and the federal budget. If the FY 83 proposals are accepted by Congress, they would turn back the clock on state-local-federal financial relationships to 1965 levels.

Another vivid example of the impact of FY 83 proposals is to examine proposed budget authority. As Table II shows, using FY 81 as a base year, grants in FY 83 will have only 53 percent (authority) or 74 percent (outlays) of the purchasing power needed to maintain constant program levels. This is a cut of 47 percent in purchasing power in two years for authority and 26 percent for outlays. These are OMB numbers.

These reductions in purchasing power are sizable enough to have a major effect on state and local governments, private providers of services paid with grants, and the recipients of services. How the losses are likely to be shared among these groups depends both upon the nature of individual cuts and the programs in which they are made.

As was the case with the FY 1982 cuts, it is likely that a substantial percentage of these cuts will, of necessity, be "passed through" to state and local governments, so that the ultimate effects will fall upon service recipients. States are largely unable to increase taxes in the current economic climate. Other program cuts, such as outlay reductions in capital and construction programs (e.g., transit, waste water treatment, and highways) will have the short term effect of slowing the pace of capital acquisition, with attendant effects on jobs in the private sector and service availability, but with little immediate impact on the solvency of state and local governments. Over the longer term, however, pressures will build to provide state and local funds to finance the needed construction at inflated costs.

Other cuts will have a more substantial and direct effect on the finances of state and local governments. In the case of Medicaid, the Administration proposes two kinds of reductions:

(1) reductions in total program costs which are generally designed to encourage more efficient service and more prudent use of medical care; and

(2) cost shifts from the federal to the state and local levels through error rate sanctions, reduced administrative costs, reduction in matching rates and the end of federal participation in the cost of Part B Medicare Insurance.

Block Grants

The Governors will continue to urge Congress to rationalize the current federal aid system through increased reliance on state and local laws and procedures, fewer mandates and regulations, more revenue sharing and block grants funding procedures. We are also hopeful we can reach agreement on a major new federalism initiative with the President. Members of Congress are also offering some major initiatives that we hope to support.

Block grants are certainly better than tens of programs for the same recipient and purpose, but only with flexibility and adequate funding. Few Governors will be interested in a repetition of last year's experience. We proposed a one-time 10 percent cut and significant flexibility in order to target funds according to state priorities. We got 20 percent cuts last year, with further large cuts proposed for FY 1983, and very little flexibility from Congress. I repeat my observation that the people are insisting that each level of government develop a lot more trust in place of the current hodge-podge of mandates, regulations, financial shifts and overhead costs. I urge this committee to take a lead role in examining major new proposals to simplify the grant-in-aid system for their positive possibilities and specific application. In this regard we applaud Congress for passing the State and Local Government Fiscal Impact Act last year.

We urge you, at a minimum, to hold the new block grants harmless from further cuts in FY 1983 and to increase our flexibility for administration of block grants. Attached is an NGA analysis of block grant funding. Table III shows that funding reductions for the block grants between FY 1982 and FY 1983 range from 71.3 percent to 0 percent; overall, the blocks are to be reduced by 15.7 percent more in FY 1983. We are in opposition to the proposed 15.7 percent cut in these programs. Such cuts can only result in drastic service reductions, serious administrative problems and further public dissatisfaction.

Conclusion

Governors will continue to consult with the President on his major New Federalism reform proposals. We will also consult with the Congress. We will oppose many of the proposed FY 1983 budget cuts. We believe that block grants should not be cut beyond FY 1982 reconciliation levels, that defense and indexed entitlements should share the burden of restraint, and that Congress should carefully weigh the bipartisan principles of federalism that the Governors continue to press in Washington

Table I

Grants in Relation to Total Budgets

Federal Fiscal Year	Grants as Percentage of Federal Outlays	State/Local Budgets
1965	9.2	15.3
1970	12.3	19.2
1975	15.4	23.0
1980	15.9	26.3
1981	14.4	25.3
1983	10.7	18.3
1985	9.6	16.1

Table II

Grant Allocations in Relation to Purchasing Power
($ billions)

	Budget Authority	Outlays
FY 1981 Actual	$105.8	$ 94.8
Amount required in FY 1983 to Maintain FY 1981 Purchasing Power	122.7	110.0
Amount in Administration Budget, FY 1983	65.2	81.4
Administration Recommendation as Percent of Amount Required to Maintain FY 1981 Purchasing Power of Grants, FY 1983	53%	74%

Table III

FY 1983 Block Grant Proposals
($ millions)

	Budget Authority			Percentage Change	
	FY 1981	FY 1982	FY 1983	FY 1981-83	FY 1982-83
Social Services	2,991.0	2,400.0	1,974.1	-34.0%	-17.7%
ADAMHA	548.6	432.1	432.0	-21.3%	- 0 -
Preventive Health	99.2	81.6	81.6	-17.7%	- 0 -
Community Services	472.7	348.0	100.0	-78.8%	-71.3%
Community Development	3,695.0	3,456.0	3,456.0	-6.5%	- 0 -
Education (Chap. 2 ECIA)	521.8	470.7	433.0	-17.0%	-8.0%
Low Income Energy Assistance	1,905.0	1,807.2	1,300.0	-31.8%	-28.1%
(Including Emergency Assistance)	(55.0)	(55.2)	—		
Primary Care (Including migrant health, black lung clinics, and family planning)	535.0	414.8	416.8	-22.1%	+0.5%
Services for Women, Infants, and Children (Including MCH and WIC programs)	1,384.5	1,281.6	1,000.0	-27.8%	-22.0%
Child Welfare (Including Child Welfare Services, Foster Care, Adoption Assistance, and CW Training programs	522.9	465.1	380.1	-27.3%	-18.3%
Combined Welfare Administration	2,125.0	2,296.0	2,181.0	+2.6%	-5.0%
Vocational and Adult Education	774.5	732.5	500.0	-35.4%	-31.7%
Education for the Handicapped	1,025.2	1,042.1	846.0	-17.5%	-18.8%
Training and Employment	6,095.0	2,252.0	1,800.0	-70.5%	-20.1%
Rehabilitation Services	923.7	925.0	623.5	-32.5%	-32.6%
Rental Rehabilitation Grants	—	—	150.0	N/A	N/A
TOTAL	23,619.1	18,404.7	15,524.1	-34.3%	-15.7%

National Governors' Association

Richard A. Snelling
Governor of Vermont
Chairman

Stephen B. Farber
Executive Director

NGA FEDERALISM POLICY

The time is at hand for national debate and action on the roles and responsibilities of federal, state and local government. The President, in his State of the Union message, set out a bold and specific proposal to realign the federal system to achieve more effective and accountable government at all levels.

The Governors have, with an increasing sense of urgency, placed federalism reform at the top of their national agenda. We share the President's strong dedication to the concept of federalism. We therefore believe it critical to present to Congress in the immediate future a proposal based on our common goals, and to continue to discuss areas of disagreement.

Our policy statements set forth many federalism principles and guidelines that are compatible with the President's proposals. We are in full accord with the President's proposal for a federal assumption of Medicaid. We also welcome his far reaching suggestion that a range of categorical programs be transferred to state responsibility. And we believe, as does the President, that a mechanism for financial transition is essential.

The President's federalism proposals contain some elements that are not consistent with existing policy positions of the National Governors' Association, such as assigning responsibilities for food stamps and AFDC to the states. The Governors also believe that support for state and local governments should not be cut in the 1983 budget to the extent that state governments are weakened and left without the capacity to meet the new service delivery requirements of the President's plan for 1984 and beyond.

The Governors believe that these differences can either be reconciled by negotiation or temporarily set aside as we build a program based on existing areas of mutual agreement. The Governors believe that our areas of agreement with the President's proposal form the basis of a revolutionary restructuring of our federal system. The proposals which follow are intended to identify areas of consensus and to suggest a federalism initiative premised upon those existing areas of agreement. The Governors stand ready to enter into immediate discussions with the Administration concerning these areas of agreement and the subjects left open in our proposal. Our goal is to keep the federalism issue before the American people and to work with the President and the Congress at every opportunity to restore balance to our system of government. To this end, we make the following proposal:

1. The federal government assumes full responsibility for Medicaid. Depending on the specific features of a federalized Medicaid program, the states and territories could save $19 billion in fiscal year 1984. The exact savings to the states and territories depend upon the fiscal year 1983 appropriations levels and the services actually assumed by the federal government.

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2. The AFDC-food stamp portion of the original proposal is deferred for further negotiations. The states and territories will continue discussions on the details of a later proposal for AFDC and food stamps.

3. The states and territories take over some negotiated set of federal categorical programs (excluding transportation programs). The cost will depend upon the actual dollar amount of the programs assumed by the states and territories as set by fiscal year 1983 appropriations. Using fiscal year 1982 cost estimates the states could assume approximately \$31 billion in program turnbacks, beginning in fiscal year 1984. Decisions on programs returned to the states will be made in a spirit of partnership and cooperation with local governments.

4. During the first year states and territories would be required to fund all programs at the previous year's level. Over the next three years, states and territories could redirect each year one-third of the total funds for assumed programs to any purpose. By fiscal year 1987, the states and territories would have full discretion over the use of the funds.

5. The transportation programs and the highway trust fund would be dealt with separately.

6. The cost to the states and territories of the returned programs is in excess of the federal government's estimated cost to assume Medicaid programs. A trust fund would be created at the level of the swap difference (presently estimated at \$12 billion). The trust fund would not increase in size, and would be funded from any federal revenue sources.

7. During fiscal year 1984 distribution of the trust fund would be based on historical expenditure levels to hold states harmless. In fiscal year 1985, 20% of the fund could be distributed according to the fiscal capacity of the states; in fiscal year 1986, 40%; in fiscal year 1987, 60%; in fiscal year 1988, 80%; and in fiscal year 1989, 100% could be distributed based upon fiscal capacity.

8. In fiscal year 1989, the President and Congress would re-evaluate the total amount required for the trust fund, and determine the most efficient manner to allow the states and territories to retain the appropriate revenue base for returned services.

National Governors' Association

Richard A. Snelling
Governor of Vermont
Chairman

Stephen B. Farber
Executive Director

December 4, 1981

The President
The White House
Washington, D.C. 20500

Dear Mr. President:

As your first year in the White House draws to a close, I want to express, on behalf of the nation's Governors, continued support for your goals of strengthening both our federal system of government and our national economy. As you noted in a recent interview, the Governors were of significant help to you in both areas this year.

Although we did not obtain as much flexibility to administer federal programs as we (and you) would have liked, and although we did not see eye-to-eye on all budget issues, the numerous meetings we have had with you have been useful and productive from our viewpoint, and I hope from yours. We appreciate the progress that has been made in consolidating grant programs and in streamlining federal regulations, and we want to continue to work with you in pursuing these important objectives.

At the same time, we must report to you that while we continue to support your broad goals, we disagree in some specific areas, as we indicated to you on September 24, on the best means of achieving them. There is strong bipartisan concern among the Governors that further drastic reductions in federal domestic programs cannot be pursued without inflicting additional hardships on those in need. Similarly, while we fully support your goal of strengthening our military defense capability, we also believe that a sound economy, an adequate transportation system, and a well-educated and highly-trained workforce are also essential to our national security.

In accordance with these concerns, our Executive Committee and Standing Committee Chairmen would like to emphasize the following points:

1. To help control federal spending and to provide needed stability in state budgeting, we propose -- as your budget plan of March 10 suggested -- level funding in nonentitlement grant programs in FY 1983 and 1984 with no adjustment for inflation.

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2. Pursuant to our sorting out agenda, we propose that any further cuts in discretionary grant programs be accompanied by comparable increases in the federal share of Medicaid and AFDC. We oppose efforts to reduce the federal responsibility for these income security programs.

3. Cuts in entitlement programs to date have been focused disproportionately on those based on need, particularly the state-federal programs, AFDC and Medicaid. As further spending reductions are considered, we believe that defense, indexed entitlements, and tax expenditures must all receive close scrutiny.

4. If the economic recovery program is to succeed, we believe that the nation's public works and capital infrastructure needs must be more effectively addressed. The current impasse over funding for the wastewater treatment construction program for FY 1982 must be resolved immediately.

Finally, because we believe that the potential for cooperation between the federal government and the states has not yet been fully tapped, we propose that your Administration join with us in a domestic summit to develop a consensus for achieving the goals that we share. This summit could involve the bipartisan leadership of the Congress and the National Governors' Association, as well as elected local officials. Its purpose would be to agree on specific goals for reducing the federal deficit and to devise an equitable distribution of resources and responsibilities among the federal, state and local governments.

Under your leadership, I believe that a domestic summit could significantly aid you in developing a consensus on what will be otherwise intensely divisive issues in the years ahead. As such, it will bring the nation tangible benefits in terms of a stronger economy and a more responsive political system. Equally important, it would dramatize, as few other steps could, the depth of your commitment to restoring our federal system.

Sincerely,

Richard A. Snelling

Governor Richard A. Snelling

National Conference of State Legislatures

National Governors' Association
HALL OF THE STATES
444 North Capitol Street • Washington, D.C. 2000[illegible]
(202) 624-5400 (202) 624-5300

February 5, 1982

THE PRESIDENT'S FEDERALISM INITIATIVE

On January 26, President Reagan announced a major federalism initiative, designed to take effect in FY 1984. The purpose of this information memorandum is to provide details on the proposal and to outline some of the major issues associated with it from the states' perspective.

THE PRESIDENT'S PROPOSAL

The following elements of the President's federalism initiative have been proposed and are now being negotiated with the states:

- The "swap" component would involve federal absorption of $19.1 billion in state Medicaid expenditures and state absorption of $16.5 billion in federal AFDC and food stamp costs. These are FY 1984 numbers and assume implementation of major cuts in the AFDC and food stamp programs in FY 1982 and FY 1983.

- The "turnback" component would involve the return of 124 grant programs (sometimes consolidated into 43 generic groups) amounting to $30.2 billion in FY 1984. About $5 billion in FY 1983 cuts are assumed.

- A federalism trust fund of $28 billion would finance the program turnback and equalize gains and losses among states caused by the swap. Of the $28 billion fund, $16.7 billion would come from the windfall profits tax and the remaining $11.3 billion would come from federal excise taxes on gasoline, tobacco, alcohol, and telephone service.

- Between 1984 and 1987, states could opt to receive the funds they would have gotten under the 124 categorical programs either through the categorical structure or without the categorical restrictions (similar to General Revenue Sharing). This transition period would end in FY 1988, when the categorical grants would be terminated.

- Also beginning in FY 1988, the trust fund would decline by 25% each year, with states raising taxes or cutting programs accordingly.

- States opting to receive funds through the categorical programs must pay related federal administrative costs.

- Aid received by states through the trust fund is subject to local pass-through requirements. 100% of aid that would have been allocated through direct federal-local grants must be passed through. 15% of all other non-education funds must be passed through. The General Revenue Sharing formula would be used to allocate pass-through monies.

- States would berequired to maintain basic AFDC and food stamp benefit levels under the swap, but no details have yet been developed.

THE STATE PERSPECTIVE

The President's program recognizes a number of principles that the states have long believed to be essential to a successful federalism reform initiative. These include the following:

- a greater federal role in one major income security program (demonstrated by full federal assumption of the Medicaid program);

- a greater federal role in health care cost containment;

- an extended transition period;

- equity in the state-by-state effect of any proposal; and

- simplification of the current grant-in-aid system.

However, there are a number of issues which must be resolved before the states can take a firm position on the Administration's federalism package. These include the following:

Issues Relating to the Swap

1. Is the swap consistent with the states' view of the appropriate federal role in the federal system?

   Governors and State Legislators have long held that income security is a federal function because people should have equal protection from want no matter where they live, because the cost of providing assistance is so great that states--with their unequal tax capacities--would find it difficult to support the program, and because need is determined largely by national economic policy which the states cannot control. Moreover, a national response is required for extraordinary circumstances--such as very high unemployment in a particular sector or a natural disaster--which drain the ability of the states where they occur to support the program needs created.

   While the President's proposal incorporates part of the states' position by suggesting a larger federal role in Medicaid, it also assumes reduced federal responsibilities in other important income security programs.

2. <u>Are the calculations of relative federal and state gain/loss under the "swap" based on figures agreed to by the states?</u>

The President's proposal is based on the assumption that state contributions to the Medicaid program will grow to $19.1 billion in FY 1984, a level consistent with the state projections. However, the proposal assumes that the federal share of the food stamps and AFDC programs will be just $16.5 billion, or $4.1 billion less than the amount that the preliminary Congressional Budget Office figures show will be necessary to maintain the current programs in FY 1984. According to the CBO projections, therefore, instead of being a trade favorable to the states by $2.6 billion in the first year, it is unfavorable by $1.5 billion. (see Figure A)

It is important to note that although Medicaid is viewed as one of the fastest growing federal programs, the growth of combined federal payments under AFDC and food stamps outstripped Medicaid growth in the period FY 1978-FY 1981. In those years, federal Medicaid payments grew 54% while federal AFDC/food stamp contributions grew 63%.

The Administration has assumed 5.8% real growth in Medicaid between FY 1984 and 1991 (as compared to a 6.3% rate between FY 1978 and 1982) with an annual inflation rate of 4% and unemployment a constant 5.5%. The President's proposal has valued the AFDC/food stamp program at no real growth (as compared to 8.8% between FY 1978 and 1982). Thus, all of what would have been the state share of these expected cost increases for Medicaid are considered savings and is added to the resources available to the states to take over additional program responsibilities as the trust fund expires. Similarly, the reduced costs projected by the Administration for the AFDC and food stamp programs are counted as savings to the states.

3. <u>What are the federal plans for the Medicaid program?</u>

The state-by-state differences in the Medicaid program have been widely discussed, and it has been suggested that the federal government would have to level this disparity in a national program. A crucial element of the federalism proposal is how the federal Medicaid program would be designed.

This question is important for all states, but it is vital for the "winners" under the swap because they will be forfeiting their allocations under the trust fund to offset their gains in the trade. If the Medicaid program is substantially curtailed (e.g., only basic services are covered, or only welfare recipients are covered), then the "winning" states will be pressured to fund both supplements to the Medicaid program and activities formerly supported by categorical grants with the same dollars. They become losers under these circumstances.

Specific questions that need to be resolved include:

- Will the federal government equalize the state-by-state differences in the Medicaid program? If so, how?

- How can the states be assured that this restructuring will not shift costs back to the states by denying eligibility to groups of current recipients, e.g. the medically needy, or by eliminating rapidly growing services, e.g. long-term care? (One suggestion for a federalized Medicaid program has been that the mandatory services would be continued, but that optional programs would be dropped. Currently, one-third of total Medicaid costs are spent on two optional services -- intermediate care facilities and pharmaceuticals. Ending these services would shift substantial costs to the states.)

- What assurances would states have that the national program would not be reduced substantially after adoption, shifting responsibility back to state and local government? Will the federal government accept maintenance of effort for Medicaid?

- The White House fact sheets indicate that federal assumption of Medicaid will provide about $19 billion of fiscal relief to states in FY 1984. This appears to be an accurate projection of the state share of costs for the current program. Does this also reflect the anticipated level of increased federal support due to the new federal program?

- How will eligibility for a national Medicaid program be determined? Currently, AFDC recipients are automatically eligible for Medicaid. Will this arrangement continue even after the AFDC program is shifted to the states?

4. <u>What federal requirements will be placed on states in connection with the turnback to them of food stamp and AFDC responsibilities?</u>

Specifically:

- The proposal suggests that the states will be required to meet "flexible maintenance of benefit requirements". Does this apply to both current and potential recipients and will it require a minimum benefit or the maintenance of existing benefits in even the highest benefit states?

- Will states be required to continue to provide services to all recipients who are now eligible for AFDC and food stamps, as well as to maintain benefit levels?

- Will future reductions in the remaining federal income security programs, such as veterans assistance and housing, force states to substantially increase state costs to maintain the current minimum level of AFDC benefits?

- How will the states be assisted to meet unusually high income security costs that may result from the impact of federal policy on trade and the economy as a whole?

- Has the federal government reached any decision in relation to its role in the unemployment and employment service activities? Will these decisions have any impact on state income assistance burdens?

Issues Relating to the Turnback

1. Does the gradual reduction and phase out of the trust fund by FY 1991 provide for equity in funding in relation to state need?

   The formulas under which funds for many of the programs now on the turnback list are distributed use some measure of need to determine state allocations. By using the average of the years FY 1979, 1980 and 1981, the proposal locks in the needs based distribution for twelve years. One issue to decide is whether some flexibility should be developed, perhaps through use of a portion of the trust fund aimed at areas of greatest service need or of lowest tax capacity. The nation's demographics argue that many changes will take place over these twelve years.

   The final phase out of the trust fund may not adequately recognize state fiscal disparities. Efforts should be directed toward improving this final phase in order to establish some protections. One way to approach this, especially if states are asked to bear a major responsibility for income security programs, would be to establish a permanent fiscal capacity equalization fund to replace the federalism funds after 1991.

2. Are the revenues sources being turned back appropriate for use by states to fund the programs included in the turnback?

   The trust fund, which phases out completely in FY 1991, contains two revenue sources: federal excise taxes and the crude oil windfall profits tax. Excise taxes do not keep pace with inflation and thus are commensurate with the rate of growth of grant-in-aid programs only if the programs decline in real dollars over time. Excise taxes, like sales taxes, also place a relatively heavier burden on lower income households. The state-by-state consumption patterns of these goods are largely unrelated to the need for the services. The exception is the motor fuel excise tax (two cents to be returned) which is directly related to the non-interstate highway programs.

   The crude oil windfall profits tax is directed at oil producers. It cannot necessarily be assumed by states when the trust fund phases down because the majority of the oil production occurs in five states. Only 23 states have any production capacity whatsoever. Moreover, the structure of this tax originally was a "profit" tax, which was not designed to be passed on to consumers. Thus there would not necessarily be a price decrease by the producers when the federal tax expired. If the windfall profits tax were converted to an excise tax at the pump, consumers would be paying 14¢ more per gallon of gas.

Senator David Durenberger (R-MN) has proposed that a portion of the federal income tax be dedicated to the state trust fund. He noted that an equalizing formula could be used to distribute such funds. The federal income tax, which is more progressive and responsive to inflation (even after the indexation which is scheduled to begin in FY 1985), might more closely match the characteristics and rate of growth of the programs being turned back.

From 1978 to 1981, federal excise tax collections rose about 5% while inflation rose more than 30%. Individual income tax collections rose more than 35%.

3. Is the size of the trust fund adequate to support the responsibilities returned to the states?

The Administration has proposed that \$28 billion in federal revenues be traded for \$30.2 billion in programs. However, an OMB spokesman has indicated that the FY 1982 funding for the 124 programs involved was \$35.2 billion. The Administration has said that the trust fund will be expanded to reflect the spending levels set by Congress for programs turned back.

As noted above, the "swap" may be disadvantageous to the states by \$1.5 billion. Adding the \$7.2 billion shortfall between the \$28 billion trust fund and the \$35.2 billion in program responsibilities, the federalism initiative as now described costs the states about \$9 billion in reduced federal aid or new state costs in FY 1984.

4. Are the programs to be turned back appropriate responsibilities for states as opposed to the federal government?[1]

The consistent policy of the states has been that income security programs should be the responsibility of the federal government. Of the programs listed, several, including the WIC program (Women Infants and Children), WIN (Work Incentive Program), Low Income Energy Assistance and the Community Service Block Grant fall into the general category of anti-poverty income assistance. The Legal Services Programs and the CETA program also may be responsibilities whose proposed transfer should be discussed further.

At the present time, it is the position of the states that they are willing to assume primary responsibility for programs in the areas of education, transportation, and law enforcement. Hundreds of small categorical grants remain in the intergovernmental system after the

[1] The listing of the programs being proposed for return to the states is attached as Appendix A.

proposed turnback, and some of these may be better candidates for state responsibility than those initially suggested by the Administration.

5. Does the proposal adequately protect both state and local government?

The list of proposed programs does contain a number of major direct federal - local grants such as general revenue sharing, the Community Development Block Program and the Urban Development Action Grant Program. In these cases, the proposal requires a complete pass through of program funds during the four year transition phase. For other programs whose funds are grouped into the turnback, there is a requirement that 15% be passed through to local governments, regardless of whether the funds have traditionally gone to states.

FISCAL IMPACT OF THE FEDERALISM INITIATIVE

The Problem with the Numbers

It is endemic in all sorting out proposals that numbers (their choice and usage) can quickly become an issue that transcends any philosophical analysis of the proposal. The President's sorting out initiative is no exception. An example of the variance between the numbers used for costing-out the swap is contained in Table A which displays the FY 1981 actuals for the AFDC and food stamp programs, Congressional Budget Office (CBO) estimate of the FY 1984 Medicaid and AFDC and food stamp programs and the Office of Management and Budget (OMB) estimates of the same programs for FY 1984.

For Medicaid, OMB, CBO, and the states agree that it is reasonable to assume a rate of growth in state Medicaid costs of 37% from FY 1982 through FY 1984. OMB counts this growth as state costs to be "relieved" in the swap. Any economies or reductions achieved when the program is federalized are not taken into account.

It is readily apparent, however, that CBO and OMB differ markedly in their estimates of the FY 1984 costs of AFDC and food stamps to the states. The major differences found between CBO's and OMB's estimates of AFDC and food stamps are attributable to two factors. First, OMB assumes that substantial budget cuts will occur before FY 1984 in these two programs. Reports in the press estimate the reductions to exceed $5 billion. CBO, in contrast, assumes that the current program structures would remain unchanged into FY 1984. The second major difference is the economic assumption used in the projection. OMB's model assumes a more optimistic economic climate in FY 1984 than CBO's.

The effect of these differing estimation techniques can be seen by comparing the total program costs estimated by OMB in FY 1984 with current costs. OMB shows a decrease in combined AFDC and food stamp costs of 10.7% over the next three years. CBO shows an increase for the same programs of 12.2% in the same time period.

States should consult with their own budget staff regarding their state's projected AFDC, food stamp, and Medicaid costs estimates. Table A is provided for illustrative purposes, and states should reach their own conclusions regarding the relative impact of the swap proposals.

In the meantime, the states have requested that OMB provide more detailed explanation of their assumptions so that state and Administration analyses can proceed from a common information base.

A Preliminary Analysis of the Impact of the Initiative

Table B is an analysis of the swap proposal using CBO's estimates of Medicaid, AFDC, and food stamp costs. The turnback programs have been adjusted upward by $5 billion to better reflect the current costs of the 124 programs slated for turnback to the states. While the initial White House background materials on the swap assessed the cost of the turnback programs at $30.2 billion, OMB spokesman Ed Dale indicated that the turnback estimate did not take into account planned program reductions of about $5 billion. In the absence of more detailed program information, we have accepted the initial OMB state-by-state estimates readjusted to reflect current program costs.

The column headed "Net Costs States" reflects the cost of the turnback programs plus the cost of the AFDC and food stamp programs less the Medicaid savings realized by the federal assumption of Medicaid. The adjacent column shows the initial White House estimate of the trust fund allocation needed to balance out state losses. Please note that while the trust fund allocation is estimated to be $27.6 billion, the trust fund receipts are estimated to be $28.0 billion. In all cases the initial trust fund allocation is inadequate to cover the costs to states for the turnback programs. Overall, the trust fund is $9.1 billion less than needed to hold the states harmless in FY 1984, without assessing the impact of inflation on the turnback programs (other than AFDC, food stamps and Medicaid).

The notes at the bottom of the chart reflect the net costs or gains to states in the tradeoff of Medicaid for food stamps and AFDC. Twelve states were net gainers in the swap, and these were usually very large gains, reflecting current high state Medicaid costs. There were 39 losers reflecting generally smaller losses compared to the winners' shares.

Overall, in the Medicaid for AFDC and food stamp swap, the winners gained by $3.1 billion and the losers lost by $4.6 billion. In the aggregate, the swap is $1.5 billion short of an even trade to the states.

While the White House appears to accept the principle that the trust fund will be sufficient to balance out these differences in FY 1984, there is a considerable gap between their estimates of the funding level required and CBO's projection of state costs to be assumed. This difference is about $9 billion short of the amount needed to hold states harmless in FY 1984. This difference might suggest the dimension of the cuts to be proposed by the Administration for these programs in FY 1983.

Preliminary Analysis of the Trust Fund Revenues

There are three major issues regarding the proposed trust fund revenues:

- their adequacy for the responsibilities returned - in both the short and long run;
- each state's access to the sources; and
- the relative revenue raising capacity by state compared with the relative state program burden.

Table C address these issues. The adequacy question is answered in the chart run by the totals of the three columns. The first column shows the new state responsibilities as a result of the 124 program turnback and the outcome of the Medicaid - AFDC/food stamp swap. The second is the relative access which states have to the two revenue sources: the federal excise taxes and the windfall profits tax. The fourth column is the net difference. According to our calculations, the trust fund is approximately $9 billion short of the expected responsibilities in the first year. In current negotiations, however, the White House has agreed to make the trust fund eventually equal to actual FY 1984 program levels.

In the long run, the match is dependent on the elasticity of the tax when compared to the elasticity of the program costs. No provision is made for an increase in the trust fund after the first year. The states believe they are able to provide adequate levels of service in the program areas for which they are assuming responsibility more efficiently than the federal government. However, the precise degree of savings that can be achieved and whether the savings will fully offset the costs of inflation is difficult to assess. It would be unrealistic to expect the states to be able to fund any given level of services for eight years without experiencing a need for greater revenues.

No attempt was made here to run a model of the economy through 1991 in order to measure program costs against revenue raising capacity; only current or near term projections of growth are shown.

In view of the inelasticity of the excise taxes and the inflation affecting program costs, the future comparison between responsibilities and revenues turned back needs careful study.

Column three addresses the relative access of states to the taxes turned back. Those states with oil production (five states have 80%: only 23 states have any) are the only ones that can touch a producers' oil tax, which accounts for 60% of the trust fund. Thus in per capita terms, their access to these funds is enormously superior.

The question of the state-by-state match between the new responsibilities and the trust fund revenues is skewed by the windfall profits tax. To measure this match, we have taken only the excise taxes and shown each state's percentage share of any national revenues (column 5). In the final column we have broken down the new state responsibilities (column 1) into state-by-state percentage shares. The aggregate figures here would be quite different ($11.3 billion vs $36.7 billion), but the percentages allow for study of the likely winners and losers from such a match if the totals were more closely aligned. Whatever tax source is considered for a turnback, this comparison will yield important information.

NGA staff contact: Deirdre Riemer (202) 624-5390
NCSL staff contact: Tim Masanz (202) 624-5408

APPENDIX A: ILLUSTRATIVE LIST OF PROGRAMS FOR TURNBACK TO THE STATES

Category/Program	Number of Grants Made in FY 1981 and FY 1984 Funding Level
Education & Training (5)	$3.3 billion
Vocational Rehabilitation	5
Vocational & Adult Education	13
State Block Grants (ECIA Ch. 2)	28
CETA	8
WIN	1
	55
Income Assistance (1)	$1.3 billion
Low Income Home Energy Assistance	1
Social, Health & Nutrition Services (18)	$8 billion
Child Nutrition	4
Child Welfare	1
Adoption Assistance	1
Foster Care	1
Runaway Youth	1
Child Abuse	1
Social Services Block Grant	3
Legal Services	1
Community Services Block Grant	8
Prevention Block Grant	8
Alocohol, Drug Abuse & Mental Health Block Grant	5
Primary Care Block Grant	1
Maternal & Child Health Block Grant	7
Primary Care Research & Development	1
Black Lung Clinics	1
Migrant Health Clinics	1
Family Planning	1
Women, Infants & Children (WIC)	1
	47

Transportation (12)	$6.4 billion
Grants-in-Aid for Airports	2
Highways:	7
Primary	
Rural	
Urban	
Bridge	
Construction Safety	
Other	
Interstate Transfer	1
Appalachian Highways	1
Urban Mass Transit:	
Construction	1
Operating	1
	13
Community Development & Facilities (6)	$6.4 billion
Water & Sewer:	2
Grants	
Loans	
Community Facilities Loans	1
Community Development Block Grant	2
Urban Development Action Grants	1
Waste Water Treatment Grants	1
	7
Revenue Sharing & Technical Assistance (2)	$4.8 billion
OSHA State Grants	1
General Revenue Sharing	1
	2
GRAND TOTALS:	
Programs	44
Grants made in 1981	125
Funding	$30.2 billion

TABLE A

COMPARISONS OF SWAP COMPONENTS ESTIMATES

($ Millions)

STATE	FY '81 ACTUALS		FY '84 CBO EST.		FY '84 OMB EST.	
	MED.	AFDC + FS	MED.	AFDC + FS	MED.	AFDC + FS
ALABAMA	88.68	375.00	137.00	432.00	140.00	350.00
ALASKA	25.66	53.00	35.00	60.00	32.00	53.00
ARIZONA	0.00	160.00	0.00	186.00	0.00	157.00
ARKANSAS	83.97	189.00	116.00	217.00	137.00	174.00
CALIFORNIA	2004.93	2124.00	2770.00	2322.00	2524.00	2030.00
COLORADO	111.59	146.00	157.00	165.00	161.00	134.00
CONNECTICUT	205.37	185.00	286.00	204.00	277.00	169.00
DELAWARE	30.91	47.00	40.00	53.00	38.00	40.00
D.C.	84.98	103.00	128.00	115.00	141.00	84.00
FLORIDA	220.73	770.00	320.00	876.00	348.00	629.00
GEORGIA	193.26	462.00	270.00	526.00	285.00	431.00
HAWAII	64.04	122.00	88.00	137.00	94.00	106.00
IDAHO	20.70	53.00	32.00	60.00	31.00	51.00
ILLINOIS	801.71	968.00	1002.00	1069.00	857.00	838.00
INDIANA	210.14	306.00	329.00	349.00	336.00	275.00
IOWA	125.99	174.00	169.00	193.00	166.00	140.00
KANSAS	109.62	108.00	145.00	120.00	141.00	94.00
KENTUCKY	122.14	397.00	160.00	452.00	186.00	367.00
LOUISIANA	142.14	395.00	259.00	451.00	309.00	379.00
MAINE	49.65	114.00	77.00	128.00	81.00	102.00
MARYLAND	253.87	310.00	341.00	348.00	342.00	283.00
MASSACHUSSETTS	579.34	503.00	744.00	554.00	669.00	418.00
MICHIGAN	706.71	1057.00	1005.00	1163.00	914.00	874.00
MINNESOTA	316.18	239.00	482.00	262.00	501.00	202.00
MISSISSIPPI	60.95	297.00	92.00	342.00	109.00	293.00
MISSOURI	170.64	320.00	240.00	361.00	247.00	296.00
MONTANA	26.23	38.00	37.00	43.00	43.00	38.00
NEBRASKA	60.14	64.00	90.00	72.00	77.00	60.00
NEVADA	35.87	33.00	52.00	38.00	70.00	30.00
NEW HAMPSHIRE	33.37	47.00	51.00	53.00	57.00	40.00
NEW JERSEY	438.[illegible]	6[illegible]3.00	6[illegible]2.00	[illegible]	552.00	426.00
NEW MEXICO	31.58	13[illegible].00	49.00	15[illegible].00	57.00	120.00
NEW YORK	3035.45	[illegible]579.00	3999.00	21[illegible]1.00	4002.00	1573.00
NORTH CAROLINA	167.65	404.00	[illegible]49.00	4[illegible]8.00	277.00	375.00
NORTH DAKOTA	24.91	24.00	39.00	[illegible]	45.00	22.00

TABLE A

(Continued)

STATE	FY '81 ACTUALS MED.	FY '81 ACTUALS AFDC + FS	FY '84 CBO EST. MED.	FY '84 CBO EST. AFDC + FS	FY '84 OMB EST. MED.	FY '84 OMB EST. AFDC + FS
OHIO	515.80	914.00	719.00	1025.00	744.00	815.00
OKLAHOMA	137.40	160.00	193.00	179.00	228.00	146.00
OREGON	100.50	216.00	138.00	246.00	128.00	165.00
PENNSYLVANIA	697.10	998.00	965.00	1116.00	967.00	875.00
RHODE ISLAND	78.90	88.00	105.00	97.00	95.00	78.00
SOUTH CAROLINA	89.00	286.00	118.00	328.00	128.00	282.00
SOUTH DAKOTA	20.70	37.00	32.00	41.00	32.00	33.00
TENNESSEE	144.60	428.00	231.00	494.00	267.00	401.00
TEXAS	548.10	756.00	705.00	876.00	833.00	726.00
UTAH	33.40	69.00	47.00	77.00	61.00	60.00
VERMONT	24.70	51.00	35.00	56.00	32.00	53.00
VIRGINIA	195.30	322.00	283.00	365.00	250.00	288.00
WASHINGTON	223.80	280.00	275.00	313.00	248.00	240.00
WEST VIRGINIA	46.80	172.00	64.00	196.00	65.00	156.00
WISCONSIN	391.60	338.00	549.00	367.00	633.00	296.00
WYOMING	9.20	13.00	14.00	15.00	17.00	14.00
TOTAL	13944.90	18348.00	19084.00	20593.00	18980.00	16378.00

TABLE B

TOTAL SWAP PROPOSAL PROJECTED INTO FY 1984

USING SPECIFIED INFLATION ASSUMPTIONS

($ Million)

STATE	PROGRAM TURNBACKS	AFDC+FS FY '84	MEDICAID FY '84	NET COST STATES	TRUST FUND ALLOCATION
ALABAMA	586.39	432.00	137.00	881.39	713.00
ALASKA	193.52	60.00	35.00	218.52	188.00
ARIZONA	356.73	186.00	0.00	542.73	463.00
ARKANSAS	359.06	217.00	116.00	460.06	345.00
CALIFORNIA	3075.37	2322.00	2770.00	2627.37	2144.00
COLORADO	417.35	165.00	157.00	425.35	331.00
CONNECTICUT	454.66	204.00	286.00	372.66	283.00
DELAWARE	123.57	53.00	40.00	136.57	107.00
D.C.	454.66	115.00	128.00	441.66	333.00
FLORIDA	1343.00	876.00	320.00	1899.00	1433.00
GEORGIA	785.75	526.00	270.00	1041.75	819.00
HAWAII	155.05	137.00	88.00	204.05	145.00
IDAHO	152.72	60.00	32.00	180.72	151.00
ILLINOIS	1824.47	1089.00	1002.00	1911.47	1547.00
INDIANA	713.47	349.00	329.00	733.47	552.00
IOWA	415.02	193.00	169.00	439.02	330.00
KANSAS	317.10	120.00	145.00	292.10	225.00
KENTUCKY	593.39	452.00	180.00	865.39	690.00
LOUISIANA	657.51	451.00	259.00	849.51	634.00
MAINE	255.31	128.00	77.00	306.31	240.00
MARYLAND	659.84	348.00	341.00	666.84	507.00
MASSACHUSSETTS	1145.98	554.00	744.00	955.98	732.00
MICHIGAN	1382.63	1163.00	1005.00	1540.63	1147.00
MINNESOTA	623.70	262.00	482.00	403.70	236.00
MISSISSIPPI	441.84	342.00	92.00	691.84	563.00
MISSOURI	760.10	361.00	240.00	881.10	700.00
MONTANA	153.88	43.00	37.00	159.88	128.00
NEBRASKA	235.49	72.00	80.00	227.49	185.00
NEVADA	113.08	38.00	52.00	99.08	58.00
NEW HAMPSHIRE	146.89	53.00	51.00	148.89	110.00
NEW JERSEY	1210.09	693.00	612.00	1291.09	907.00
NEW MEXICO	219.17	150.00	49.00	320.17	251.00
NEW YORK	3634.95	2101.00	3998.00	1737.95	799.00
NORTH CAROLINA	841.78	460.00	249.00	1052.78	820.00
NORTH DAKOTA	124.74	27.00	39.00	112.74	83.00

Table B continued

STATE	PROGRAM TURNBACKS	AFDC+FS FY '84	MEDICAID FY '84	NET COST STATES	TRUST FUND ALLOCATION
OHIO	1556.34	1025.00	719.00	1862.34	1486.00
OKLAHOMA	387.04	179.00	193.00	373.04	249.00
OREGON	415.02	246.00	138.00	523.02	393.00
PENNSYLVANIA	2040.14	1116.00	965.00	2191.14	1658.00
RHODE ISLAND	164.38	97.00	105.00	156.38	124.00
SOUTH CAROLINA	465.15	328.00	118.00	675.15	553.00
SOUTH DAKOTA	143.39	41.00	32.00	152.39	124.00
TENNESSEE	661.01	494.00	231.00	924.01	702.00
TEXAS	1699.73	876.00	705.00	1870.73	1352.00
UTAH	213.34	77.00	47.00	243.34	182.00
VERMONT	113.08	56.00	35.00	134.08	118.00
VIRGINIA	675.00	365.00	283.00	757.00	617.00
WASHINGTON	585.23	313.00	275.00	623.23	493.00
WEST VIRGINIA	394.04	196.00	64.00	526.04	429.00
WISCONSIN	666.83	367.00	549.00	484.83	235.00
WYOMING	89.77	15.00	14.00	90.77	75.00
TOTAL	35197.70	20593.00	19084.00	36706.70	27599.00

Notes

The states that would lose in the Medicaid for AFDC and food stamp swap would lose a total of $4.6 billion.

The states that would win in the Medicaid for AFDC and food stamp swap would gain by $3.1 billion.

The trust fund is short of the cost of the turnback programs by $9.1 billion.

Assumptions

Program turnback costs are adjusted upward by $5 billion to reflect OMB's most recent estimate.

AFDC and food stamps reflect FY 1981 federal costs adjusted by CBO based on national projections of FY 1984 costs.

The Medicaid figures are based on FY 1982 state estimates of state costs adjusted by CBO.

The trust fund allocation column is the amount specified for illustrative purposes in White House information packages.

Please note that the total trust fund allocation to states does not equal the $28.0 billion estimated in trust fund receipts.

Comparison of Trust Fund Revenues and State Responsibilities

Table C

State	Net Fiscal Burden on States FY 1984[1] (millions $)	State Accessibility of Trust Fund Revenues (FY 1984 values; millions $)[2]	per capita value of trust fund revenues (column B)	Difference (B–A; millions $)	State Shares (%) of excise tax revenues only[3]	State Shares (%) of net Fiscal Burden (column A)
Alabama	$ 881.39	$ 287.29	$ 73.68	$ - 594.10	1.43 %	2.40 %
Alaska	218.52	2584.88	6430.06	2366.36	.21	.60
Arizona	542.73	137.31	50.63	- 404.82	1.21	1.48
Arkansas	460.06	217.10	94.76	- 242.96	.84	1.25
California	2627.37	3473.54	146.38	844.17	11.43	7.16
Colorado	425.35	335.57	115.88	- 89.78	1.66	1.16
Connecticut	372.66	158.01	50.72	- 214.65	1.40	1.02
Delaware	136.57	55.83	58.92	- 101.39	31	.37
D.C.	541.66	35.12	67.23	385.83	.49	1.20
Florida	1899.00	793.18	40.44	- 1105.82	5.04	5.17
Georgia	1041.75	270.00	49.29	- 771.75	2.39	2.84
Hawaii	204.05	44.73	46.21	- 159.32	.40	.56
Idaho	180.72	41.39	43.71	- 139.33	37	.49
Illinois	1911.47	805.97	70.41	- 1105.50	5.17	5.21
Indiana	733.47	301.21	56.74	- 432.26	2.24	2.00
Iowa	439.02	129.65	44.40	- 309.37	1.15	1.20
Kansas	292.10	671.35	283.39	379.25	30	.80
Kentucky	965.39	336.46	64.43	- 628.93	1.58	2.36
Louisiana	849.31	1346.33	319.34	496.52	1.57	2.31
Maine	306.31	36.72	50.29	- 249.59	.50	.83
Maryland	666.84	233.99	55.36	- 432.85	2.07	1.82
Massachusetts	953.88	309.96	53.90	- 644.02	2.74	2.60
Michigan	1540.63	666.73	71.45	- 873.90	4.04	4.20
Minnesota	403.70	210.31	51.46	- 193.39	1.86	1.10
Mississippi	691.86	266.60	105.50	- 425.26	.37	1.88
Missouri	881.10	228.52	46.36	- 652.58	2.02	2.40
Montana	159.88	225.12	285.32	65.24	.38	.44
Nebraska	227.49	128.13	81.60	- 99.36	.67	.62
Nevada	39.08	76.41	95.40	- 22.67	.68	.27
New Hampshire	148.89	52.44	89.31	- 46.45	.73	.41
New Jersey	1291.09	383.66	51.92	- 907.43	3.40	3.52
New Mexico	320.17	559.57	629.43	239.40	.56	.87
New York	1737.95	861.89	48.95	- 876.06	7.55	6.73
North Carolina	1052.70	289.92	49.26	- 762.78	2.57	2.87
North Dakota	112.74	203.04	310.46	90.30	.32	.31
Ohio	1862.34	604.61	55.36	- 1257.73	4.20	5.07
Oklahoma	373.06	1276.24	420.79	903.20	1.22	1.02
Oregon	523.02	134.37	50.99	- 388.45	1.19	1.42
Pennsylvania	2191.14	534.25	44.91	- 1656.89	4.48	5.97
Rhode Island	156.38	50.76	53.44	- 105.62	.45	.43
South Carolina	675.15	153.03	46.92	- 522.12	1.35	1.84
South Dakota	152.39	41.56	59.83	- 110.93	31	.42
Tennessee	924.01	202.08	43.91	- 721.93	1.73	2.52
Texas	1870.73	6480.13	454.33	4609.40	5.13	5.10
Utah	243.34	186.16	125.71	- 59.18	42	.66
Vermont	134.08	50.61	59.67	- 103.47	.27	.37
Virgina	757.00	258.78	48.29	- 498.22	2.29	2.06
Washington	823.23	197.90	47.80	- 625.33	1.75	1.70
West Virginia	526.04	101.35	51.87	- 424.69	.69	1.43
Wisconsin	484.83	262.36	55.62	- 222.47	2.32	1.32
Wyoming	90.77	779.40	1647.77	688.63	.29	.25
TOTAL	$ 36706.70	$ 27997.98[4]	$ 123.26	$ - 8706.79	100.039 %	100.00 %

Source: Data for columns 2,3 and 5 from Advisory Commission on Intergovernmental Relations

(1) FY 1982 value of turnback programs plus CBO FY 1984 estimate of AFDC and food stamp costs minus .80 FY 1986 estimate of state Medicaid savings.

(2) Revenues generated by state assumption of federal excise ($11.3 billion) and crude oil windfall profits ($16.7 billion) taxes; based on 1980 consumption patterns and oil production values in states.

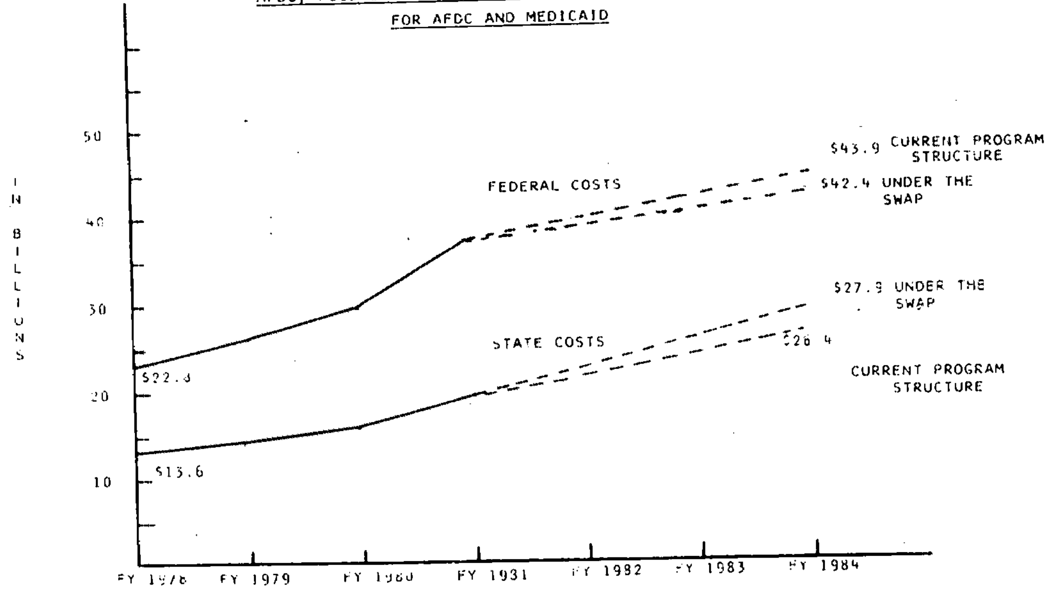
(3) Based on $11.3 billion turnback in FY 1984 (excludes the windfall profit tax revenues) and state 1980 consumption patterns.

(4) Computed by ACIR based on the orginal Administration's $28.0 billion trust fund.

Figure A

SOURCE: 1979 TO 1982 U.S. BUDGET AND CBO PROJECTIONS

PROJECTION OF CURRENT PROGRAM COSTS AND PROGRAM COSTS AFTER PROPOSED SWAP: FEDERAL COSTS FOR AFDC, FOOD STAMPS AND MEDICAID AND STATE COSTS FOR AFDC AND MEDICAID



NET EFFECT OF SWAP IS A $1.5 BILLION SHIFT IN PROGRAM COSTS TO THE STATES

The Proposed FY 1983 Federal Budget: Impact on the States

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(202) 737-7004 (after March 1, 1982)

Contents

Summary

The FY 1983 budget proposed by the President can be summarized as follows:

Outlays	\$757.6 billion
Receipts	\$666.1 billion
Deficit	\$ 91.5 billion

The deficit is projected at \$83 billion in FY 1984 and \$53 billion in FY 1987.

Outlays for grants to state and local governments drop from \$91.2 billion in FY 1982 to \$81.4 billion in FY 1983. This level maintains 74% of the FY 1981 purchasing power of grants-in-aid. Overall, grants accounted for 14.4% of federal outlays in FY 1981; they would account for 10.7% in FY 1983. Broad-based grants (block grants and revenue sharing) account for 25.4% of total grants, up from 20.6% in FY 1982.

The following are the major FY 1983 budget initiatives of interest to state governments.

BLOCK GRANTS

The budget proposes eight new grant consolidations, expansion of three of the block grants enacted last year, and continuation of seven of the existing blocks. Budget authority for all the block grants is reduced by a total of \$2.9 billion (15.7%) between FY 1982 and FY 1983.

- New block grants include:

  -- Vocational and Adult Education (combines eight programs: basic grants, program improvement and supportive services, programs of national significance, special programs for the disadvantaged, consumer and homemaker education, state advisory councils, state planning, and adult education grants to states);

  -- Education for the Handicapped (primarily consolidates Part B State Grants and Pre-school Incentive Grants under the Education of the Handicapped Act and the Chapter 1 Handicap program--run by state agencies--under the Education Consolidation and Improvement Act of 1982);

-- Employment and Training (replaces the current CETA program, WIN, and other programs for target population groups);

-- Rehabilitation Services (combines basic state grants with project grants);

-- Child Welfare (consolidates four programs: foster care, child welfare services, adoption assistance, and child welfare training);

-- Rental Rehabilitation (combines two programs: rehabilitation loans and Section 8 moderate rehabilitation);

-- Combined Welfare Administration (consolidates grants for state administration of the Medicaid, AFDC, and food stamps programs);

-- Food and Nutrition Block Grant to the U.S. territories (similar to the block grant to Puerto Rico);

- Expanded block grants include:

-- Primary care (black lung clinics, migrant health and family planning programs would again be proposed for consolidation into this block grant);

-- Services for Women, Infants, and Children (the WIC program would be combined with the existing maternal and child health block grant);

-- Energy and Emergency Assistance (the AFDC emergency assistance program would again be proposed for consolidation with the low income energy assistance program); and

- Continued block grants are Social Services, Health Prevention, Community Services, Community Development (CDBG), Education (Chapter 2 of ECIA), and Alcohol/Drug Abuse/Mental Health.

ENTITLEMENT SAVINGS

Almost half of the total $12.8 billion in entitlement program savings come from state-administered programs. Generally applicable changes include prorating the recipient's first month's payment to reflect the date of application, rounding benefits down to the nearest dollar, phased reduction in allowable error rates which are reimbursed (from 3% in FY 1983 to 0% in FY 1986), and counting energy assistance as income. In addition, the following proposals are made:

- Medicaid: $2 billion savings, which includes, in addition to the items mentioned above, a 3% federal match reduction for optional services and medically needy recipients (-$600 million), mandated recipient co-payment (-$329 million), and elimination of federal match for Medicare buy-in (-$203 million);

- SSI: stricter definition of permanent disability, ending the $20 income disregard, and recovering past overpayments through Social Security;

- AFDC: mandatory workfare and job searches (-$280 million), elimination of WIN (-$246 million), prorated housing allowances for large households (-$174 million);

- Food Stamps: raised benefit reductions for every dollar of earned income, elimination of the earned income disregard, and mandatory workfare and job search requirements;

- Child Nutrition: elimination of the special milk, summer feeding and the nutrition education programs, and conversion of the breakfast and child care feeding programs to a grant to states at 80% of the current funding level; and

- Guaranteed Student Loans: higher origination fees, tightened needs test, and elimination of the full interest subsidy for graduate students.

SPENDING PROPOSALS

Among the most important spending proposals offered by the President are:

- major reductions from current funding levels for elementary and secondary education programs including $1 billion in Title I compensatory education, $155.9 million in impact aid, and $43.5 million in bilingual education;

- a reduction to $1.8 billion from $3.4 billion for all higher education student financial aid including a 23% reduction in Pell grants, a 25% reduction for college work study grants, and the elimination of state student incentive grants, federal capital contributions for national direct student loans, and the supplemental educational opportunity grants;

- elimination of all new rental housing construction (except for elderly and handicapped), shifting to housing "vouchers", a cash payment of $2,000 per year to low-income families who would seek housing in the private market;

- maintenance of urban development action grants and the community development block grant at FY 1982 levels;

- creation of 25 enterprise zones (75 in three years), combining a variety of tax incentives and deregulatory components at all levels of government;

- elimination of all Economic Development Administration and Appalachian Regional Commission assistance programs;

- continuation of the General Revenue Sharing program for local governments at current levels;

- $2.4 billion in both FY 1982 and FY 1983 funding for wastewater treatment construction grants;

- elimination of energy conservation assistance programs including state energy conservation grants, schools and hospitals, energy extension service and low-income weatherization;

- a 19% reduction in state grants for environmental programs from FY 1982;

- a $70 million increase in spending for the superfund program;

- no FY 1983 funding for water resource planning, coastal zone management, historic preservation and state acquisitions through the Land and Water Conservation Trust Fund;

- a $9 million increase in state grants for surface mining reclamation and enforcement activities;

- elimination of funding for juvenile justice programs and the Legal Services Corporation, and the continued phase-out of the Law Enforcement Assistance Administration;

- a 10% across-the-board reduction in Older Americans Act programs;

- decreases in the obligation limitation for federal aid highways to $7.7 billion from $8.0 billion in FY 1982;

- a 38% ($396 million) reduction in the mass transit formula grants to urbanized areas from $1.0 billion in FY 1982;

- a decrease of 8% (from $2.5 billion to $2.3 billion in budget authority) for mass transit capital grants;

- a $135 million decrease in assistance to Amtrak to $600 million;

- elimination of the local rail assistance program;

- a decrease of 30% in overall funding levels for the National Endowment for the Arts programs and the National Endowment for the Humanities programs;

- a new $10 million pilot state matching grant program for soil conservation;

- expansion of state and local assistance through the Federal Emergency Management Agency (although the Fire Protection Administration is eliminated);

- elimination of the trade adjustment assistance program by July 1, 1982, except for persons already in approved training; and

- no replacement for the targeted jobs tax credit program, which expires December 31, 1982.

REVENUE RAISING MEASURES

Among the proposals offered by the President are the following:

- Restrictions on the use of industrial revenue bonds designed to raise \$1.1 billion in additional revenues by FY 1985. The proposals would deny the use of the accelerated cost recovery system for assets financed with IDBs, require public hearings and approval by elected officials on each project, involve extensive reporting and registration of the bonds, and significantly alter the structure of the bonds in 1986 by requiring a financial contribution or commitment to the bonds by the issuing government;

- A component of the minimum corporate income tax having an impact on financial institutions similar to provisions of Revenue Ruling 80-55, which disallowed deductions on interest paid by banks on state and local time deposits collateralized by tax-exempt obligations;

- User fees supporting research and development of commercial nuclear waste disposal, recreational facilities, Federal Aviation Administration activities, and Coast Guard programs; and

- The acceleration of the Outer-Continental Shelf (OCS) leasing program generating \$8.4 billion in federal revenues in FY 1983.

REORGANIZATIONS

- Energy: 90% of current Department of Energy programs would be transferred to the Department of Commerce. A new Energy Research and Technology Administration would be established in the Department of Commerce to manage energy research and development, uranium enrichment, general science and defense (nuclear weapons) activities. Other programs transferred to Commerce include energy information and energy emergency preparedness. The Department of Interior would take over the strategic petroleum reserve, naval petroleum reserves, and power marketing administration. The Department of Justice would be assigned the remaining compliance and enforcement programs relating to energy industry regulation.

- Education: The Department of Education would be abolished and replaced with a Foundation for Education Assistance headed by a director who would be appointed by the President. The Foundation would assume responsibility for block grants and consolidated aid for state and local educational agencies, student loans and grants, support for compensatory and equal educational opportunity programs and a core of informational, statistical and research services. Activities not related to education support functions would be assigned to other agencies.

Overview

INTRODUCTION

From a state perspective, the President's FY 1983 budget poses a series of difficult fiscal problems (see Summary). From a national perspective, the budget reflects a decision to advocate:

(1) continuation of the scheduled tax reductions enacted in 1981;

(2) no major changes in the Social Security program;

(3) continued expansion of defense spending; and

(4) sizable deficits, with efforts to limit them to less than $100 billion.

Given these premises, the President has found it necessary to propose major reductions in federal domestic programs.

PHILOSOPHY

Roles of State and Local Government: The budget, in both its language and its funding recommendations, reflects the conclusion that the federal government has overextended itself in matters that should be handled by state and local government and/or the private sector. The budget documents discuss in detail the growth of federal involvement in areas of state and local concern. The results of this involvement are viewed as unacceptably high federal spending, "confusion as to who is responsible for what," and unnecessary federal intrusion into areas best handled by other levels of government.

The budget documents quote the Tenth Amendment to the Constitution, which reserves to the states and the American people the powers not delegated to the federal government. The documents also contain a discussion of the increased capacity of state governments, a point that has been made repeatedly by state officials.

This philosophy is reflected in the President's federalism initiative. The proposal, designed for implementation in FY 1984 and beyond, is discussed in a later section.

The philosophy underlying the budget proposals creates a tight fiscal squeeze on federal domestic programs in FY 1983 and the years to follow. This squeeze is created by one fact of life--the enormous cost of interest on the federal debt—and four policy decisions. Those four policy decisions are:

(1) Maintaining the Tax Reduction Program. The Economic Recovery Tax Act of 1981 provided for corporate and individual tax reductions, including a phased reduction in individual rates, lower corporate taxes through depreciation adjustments, and indexing of the individual income tax to inflation. Assuming current law is not changed, federal receipts will increase in absolute terms but will drop sharply as a percentage of GNP from 21% in FY 1981 to 19.4% in FY 1983. The increase will not be large enough to maintain current policies. The budget reflects the President's commitment that the tax reductions will take place as scheduled with only minor modifications. This policy decision means that to prevent even larger deficits, the real spending of the federal government must be curtailed.

(2) Limiting the Deficit: Although this policy decision is not articulated in the budget documents, the Administration has clearly decided to provide a budget that limits the annual federal deficit to under $100 billion, a figure that many observers view as unacceptably high. The President's budget shows that the deficit gets lower each year. The combination of a constraint on revenues imposed by existing tax law and a political constraint on the deficit limits the amounts the federal government can pay for national defense, Social Security, and all other programs.

(3) Increasing Defense Spending: In 1981, the President proposed and the Congress enacted major increases in real defense spending. In the FY 1983 budget, the President demonstrates a desire to continue real increases in defense spending; real defense growth will be 13.2% in FY 1983. Given a constrained total budget, this decision reduces the amounts available for other programs.

(4) Preserving Social Security: During 1981, the President made proposals for reductions in Social Security costs which, with minor exceptions, were not accepted by Congress. These recommendations are not repeated in the FY 1983 budget. Instead, the President provides for spending which reflects a continuation of current law. Increases in the retired population and the indexing of benefits to inflation thus causes Social Security costs to increase sharply.

These four policy decisions, the necessity to pay interest on the federal debt, and obvious limitations on the Administration's ability to reduce sharply and quickly the costs in Medicare, Medicaid and retirement programs for federal employees create a tight squeeze on "all other" programs--of which grants to state and local government are a major component--during FY 1983 and later years. The magnitude of this squeeze is shown in Table 1.

Table 1: Changing Budget Priorities
($ billions)

Category	Outlays FY 1981	Outlays FY 1987	Change 1981-1987	Share of Budget FY 1981	Share of Budget FY 1987
Defense	$159.8	$364.2	+127.9%	24.3%	37.2%
Social Security	138.0	232.0	+ 68.1	21.0	23.7
Net Interest	68.7	93.2	+ 35.7	10.5	9.5
Medicare & Medicaid	59.3	107.4	+ 81.1	9.0	11.0
All Other Entitlements	94.8	98.5	+ 3.9	14.4	10.1
All Other (nondefense)	136.6	83.6	- 38.8	20.8	8.5
Total Outlays	657.2	978.8	48.9	100.0	100.0

Table 1 shows how the Administration would change budget priorities. In the six years from FY 1981 to FY 1987, defense outlays would rise by 128%, Social Security by 68%, and total outlays--constrained by revenue availability and a limit on the deficit--by only 49%. The necessary result is a decrease in the "all other" component, which is reduced by 39%. This reduction in absolute dollars results in an even greater reduction if inflation-adjusted resources are used, as shown in Table 2.

Table 2: All Other Spending Adjusted for Inflation
($ billions)

Outlays	Administration Assumed Inflation (GNP deflator)	Assumed Inflation Rate 7%	Assumed Inflation Rate 10%
Amount Needed to Maintain Purchasing Power in FY 1987 of $136.6 Billion "All Other" in FY 1981	$187.7	$205.0	$242.0
FY 1987 Amount Scheduled in Budget	83.6	83.6	83.6
Scheduled Amount as Percentage of Amount Required to Maintain Purchasing Power	44.5%	40.8%	34.5%
Real (inflation-adjusted) Purchasing Power Reduction, FY 1981-1987	55.5%	59.2%	65.5%

The magnitude of the reduction on "all other" outlays is 55.5% by 1987 in real (inflation-adjusted) purchasing power when the Administration's assumed inflation rate (GNP deflator) is used. If inflation is worse than projected by the Administration and averages 10% per year, real purchasing power of the "all other" category--which includes many state grant programs--would be reduced by 65.5% from 1981 to 1987.

The Economics of the Program

The economy is one of the strongest forces that shapes the federal budget. When the economy is healthy, costly federal programs triggered by such factors as unemployment consume fewer resources, and tax revenues reflect high growth rates. Recession, on the other hand, creates pressures for federal spending increases at the same time that it reduces revenue growth. Thus, the economic assumptions are an important part of the budget process.

In addition to its impact on the federal budget, the economic condition of the nation affects both the spending pressures and revenue availability of state and local governments.

ECONOMIC ASSUMPTIONS

There are four major economic assumptions affecting the budget: (1) the real growth in gross national product (GNP), (2) inflation, which affects the nominal GNP (and thus tax revenues) and spending by virtue of the indexing of certain programs, such as Social Security and federal retirement, (3) unemployment, which affects spending in some programs and tax receipts, and (4) interest rates, which affect the costs of financing the federal debt. These factors interact with federal budget policy and have a substantial impact on the deficit. The Congressional Budget Office (CBO) has estimated, for example, that real growth one percentage point lower than estimated would increase the FY 1982 deficit by $8 billion; one percentage point higher unemployment would increase the deficit by $19 billion.

Real Growth: Many forecasters are predicting relatively rapid economic recovery from the current recession. The Administration and CBO estimates of real growth are shown in Table 3.

Table 3: Alternative Estimates of Real GNP Growth
Percent Change Constant 1972 Dollars[1]

Source of Estimate	Calendar Year 1982	1983	1984	1985
Quarter over Quarter				
Administration	3.0	5.2	4.9	4.6
Private Economists, Average	2.9	N/A	N/A	N/A
Year over Year				
CBO "Baseline"	-0.1	4.4	3.6	3.5
Econometric Models, Average	-0.2	4.2	N/A	N/A

The real GNP growth forecast by the Administration is significantly above the postwar average of 3.5% (1947-1981), but is less than the rate that has been achieved in certain periods, such as between 1961 and 1966, when real GNP grew at an annual rate of 5.4%.

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[1] Administration forecasts from the Budget of the United States Government, FY 1983, p. 2-7; CBO from Baseline Budget Projections for Fiscal Years 1983-1987, p. xv; and private economists from Business Week (December 28, 1981), p. 88. The growth rates reflect general differences in outlook, but are not exactly comparable. CBO rates are year-to-year and Administration rates are fourth quarter to fourth quarter, which means that the Administration will show a higher number in a bad year with growth at the end (1982), while CBO will not. For 1983 and beyond, CBO and Administration numbers indicate real differences in optimism about growth. Private economist numbers are first quarter over first quarter. Econometric Models average Chase and Data Resources estimates published in the New York Times, December 28, 1981.

Inflation: Prices can be measured in several ways, as shown in Table 4.

Table 4: Alternative Measures of Price Change
Percentage Change: Year Over Year[2]

	Calendar Year					
INDICATOR/Source	Actual		Estimated			
of Estimate	1980	1981	1982	1983	1984	1985
GNP DEFLATOR						
Administration	9.0	9.1	7.9	6.0	5.0	4.7
CBO	9.0	9.1	7.5	7.3	6.6	6.0
CONSUMER PRICE INDEX						
Administration	13.5	10.3	7.3	6.0	4.6	4.8
CBO	13.5	10.3	7.5	6.9	6.9	6.4

Table 4 suggests that the Administration is somewhat more optimistic than CBO on the ability of the economic recovery plan to control inflation. However, both sets of estimates suggest that the slowing of price increases from the 1980-81 level will continue. In considering these tables, it should be remembered that economists' forecasts of both GNP and price levels have been notoriously unreliable in recent years.

Until 1985 (when federal taxes are indexed for inflation), higher price levels will help to balance the budget, because inflation brings in more money on the revenue side than it costs on the expenditure side. Thus, CBO's differences with the Administration in predicting somewhat higher prices and lower real growth more or less cancel out in the revenue estimates. CBO's estimate of revenues from current tax law is $652 billion in FY 1983 and $818 billion in FY 1986, close to the Administration's forecasts of $653 billion and $843 billion, respectively.

Unemployment: Both CBO and the Administration forecast continuing high unemployment in 1982, with a 8.9% unemployment rate, and steady declines in the unemployment rate through 1987, when CBO expects a 6.7% rate and OMB forecasts a 5.3% rate.

Interest Rates: CBO and Administration forecasts differ significantly on interest rates, which are typically measured by the rate on three month Treasury bills. This rate was 11.5% in 1980, slightly over 14% in 1981 and is expected by the Administration to drop to 11.7% in 1982 and 10.5% in 1983. CBO expects a 12% rate in 1982 and, consistent with its estimate of a heating up of the economy, an increase in 1983 to a rate of 13.2%. These differences are important in their impact on estimated deficits as well as their implications for state and local borrowing costs and the condition of the housing industry.

[2] Same source as Table 3. Definitions used by the Administration and CBO are comparable in this table.

THE FEDERAL DEFICIT

In February 1981 the Administration was discussing budget proposals involving a deficit in FY 1982 (the current year) of about $45 billion, in FY 1983 of $23 billion, and a surplus or balanced budget in FY 1984. The budget filed in February 1982 shows a current year deficit of $98.6 billion, a deficit in FY 1983--after all of the cuts advocated in the budget--of $91.5 billion, and a deficit in FY 1984 of $82.9 billion. This gives rise to the natural question: What happened?

The primary answer is that the Administration's March 1981 economic assumptions were not realized and that new economic assumptions have been adjusted for the reality of what has been happening in the economy. Real GNP change (year-over-year) is now estimated to be 0.2% in 1982 versus the 4.2% growth expected less than a year ago. Interest rates are expected to be higher--the current estimate for 1982 is for 11.7% on Treasury bills versus the estimate of 8.9% made last March. The budget attributes the shift in the deficit projections from the March estimates to economic assumption changes.[3]

FY 1983 Prospects Without Policy Change: CBO has prepared baseline projections of the federal budget (assuming no policy changes) which conform reasonably closely to Administration projections in terms of showing unprecedented deficits. The separate estimates are shown in Table 5.

Table 5: Baseline Estimates
($ billions)

ITEM/Estimator	FY 1982	FY 1983	FY 1984	FY 1985
RECEIPTS				
Administration	$626	$653	$704	$778
CBO	631	652	701	763
OUTLAYS				
Administration[4]	728	799	869	946
CBO	740	809	889	971
DEFICIT				
Administration[4]	101	146	165	168
CBO	109	157	188	208

Receipts+Deficit may not equal Outlays due to rounding.

3 Budget, p. 2-14.

4 The Administration numbers used here are slightly different conceptually from the CBO numbers. The Administration numbers are "current services base-line with adequate defense." Conceptually, this means that the Administration has added in defense budget increases before defining the deficit problem rather than identifying defense increases as one source of the problem.

The deficits shown above are fully consistent with reported Administration calculations during the budget preparation process suggesting that, without action to correct the problem, the FY 1983 budget could be in deficit from $140 to $160 billion. Deficits of this magnitude are widely viewed as being unacceptable. Such deficits would involve financing about 20% of the federal budget from borrowing and consuming nearly 5% of the GNP through federal borrowing.

Impact of Deficits: Federal budget deficits are likely to dominate much of the discussion of the President's budget, set the context for the discussion of grant appropriations, and, in the view of some, substantially affect the performance of the national economy throughout 1982. In view of their political and economic importance, this section provides a discussion of the impact of federal deficits.

- Size of Deficit: For the purposes of measuring the economic impact of the deficit on the federal government, one should use total federal borrowing from the public. This includes the impact of federal activities that are off-budget, that is, not carried in the revenue and expenditure totals discussed above. The inclusion of off-budget spending brings the Administration's projected deficits to $79 billion in FY 1981, $118 billion in FY 1982, and $107 billion in the proposed FY 1983 budget.

  The deficit does not reflect the federal impact on credit markets through guaranteed loans as, so long as there is no default, guarantees do not affect receipts or expenditures. However, federal guarantees are generally viewed as affecting the allocation of credit among borrowers and the price of credit more than total credit demand and supply.

  A deficit of $107 billion is sizeable in historical terms, but how impressive the number is depends upon the standard to which it is compared. The deficit is nearly $500 per capita--equivalent to increasing debt by about $2,000 for every American family of four. It is, however, under 4% of the nation's output of goods and services. It is about 150% of the total dividends received by individuals in 1981, but about a third of the total interest received by individuals in that year. It is about the same size as personal savings and about two-thirds of corporate after-tax profits. Such a deficit is a little smaller than the value of all retail inventories, about the same as new housing construction costs, and about equal to the cash and near-cash holdings of U.S. nonfinancial corporations.

- Impact on Economic Activity: There are a number of ways to measure how intrusive government is in the private economy. The standard used in the President's budget is the percentage of GNP taken by taxes, which is projected to decrease through FY 1986. The size of the deficit does not affect this number.

  In traditional economic analysis, a deficit is viewed as stimulative. When the government borrows money to finance current programs the impact--in traditional analysis at least-- is to cause people and factories to be more fully employed than they would be otherwise. The existence of the deficit and the tax cut scheduled for this summer are two factors that cause some economists to forecast quick recovery from the current recession.

- Impact on Interest Rates: Other things being equal, a higher deficit increases the demand for credit without a corresponding increase in the available credit. The effect should be to raise interest rates, as higher rates will increase the incentive to save and lend and reduce the incentive for businesses and individuals to borrow and spend. Thus, it is generally agreed that large deficits have some impact on interest rates. However, there is little consensus on the magnitude of this impact as it relates to the President's budget. The tax package contains a number of features (tax cuts, accelerated depreciation, tax breaks for retirement savings) designed to increase the supply of funds. Furthermore, some economists minimize the role of fiscal policy in causing interest rate changes, believing that monetary policy is a more important factor.

ADMINISTRATION BUDGET SAVINGS PLAN

The Administration has proposed a five-part program to reduce the deficit to $91.5 billion in FY 1983. That program is summarized in Table 6.

Table 6: Actions to Reduce the Deficit
($ billions)

Action		Outlay Savings, FY 1983
Entitlement Savings		11.7
(Medical Entitlements)	($5.1)	
(Cash Assistance and Nutrition)	(4.6)	
(Federal Retirement)	(0.9)	
(Other)	(1.1)	
User Fee Increases		2.5
Management Initiatives		20.3
Discretionary and Other Programs		14.2
Tax Revisions		7.2
Grand Total		$55.9

Entitlement Savings: The major savings in medical programs are associated with an "interim" 2% reduction, presumably across the board, in hospital reimbursement rates for Medicare. A variety of reductions would also be made in Medicaid, as discussed elsewhere in this report. Federal AFDC costs would be shifted to states through disallowances of reimbursement associated with error rates, and work requirements for AFDC would be strengthene Payments for AFDC and food stamps would be reduced by changes in calculating income and costs.

Retirement benefits for federal employees would be limited to the lesser of increases in federal pay and the Consumer Price Index, which lowers cost as long as pay increases continue to lag behind inflation. The current Railroad Retirement system would be converted into a private pension plan. Student assistance in higher education would be reduced by increased charges and a means test for guaranteed loans.

The budget cuts direct federal entitlements (e.g., Social Security, federal retirement, veterans compensation, SSI, food stamps) by 2.2% from current law and state-federal entitlements (e.g., Medicaid, AFDC, child nutrition) by 11.7%.

User Fees: The Administration continues to seek enactment of various user fees, some of which were rejected by Congress in 1981. The proposals include increasing the taxes on airport users, users of navigation projects, nuclear waste disposers, and boat owners and raising fees for those who use federal recreation areas.

Management Initiatives: Savings are anticipated from a number of separate actions such as "prevention of fraud, waste, and abuse," improved debt collection, long term reduction in federal employment, etc. Of the $20.3 billion in savings from this source for FY 1983, over 40% is stated as receipts from increases in leasing of Outer Continential Shelf oil and gas properties. This income source has appeared in budgets in the past, but actual revenues have often fallen well below estimates. Increases of $5.5 billion in FY 1983 receipts are included as a result of proposals to withhold taxes on dividends and interest, speed-up corporate collections, and increase IRS enforcement.

Discretionary and Other Programs: This category covers $14.2 billion of cuts from current service levels, primarily by reductions in grant programs discussed elsewhere in this paper.

Tax Revisions: The President rejected well-publicized recommendations that he propose general increases in excise taxes to help balance the budget. He also rejected proposals to increase the federal gasoline tax to maintain the level of federal financial participation in highway finance. Four of the tax proposals are quite specialized and have little impact on state and local government. They are: eliminating the completed contract method of accounting so that contractors recognize their profits earlier, ending certain business energy tax credits, modifying coinsurance activities of insurance companies, and capitalizing interest and taxes during construction of business property.

However, there are a number of proposals made in the budget or recently announced by Administration officials which would continue to restrict the ability of states and localities to use the tax-exempt market to finance public projects and long-term debt. These include the following:

(1) Minimum corporate income tax: The President has proposed to strengthen the minimum tax for corporations. The minimum tax that is currently applied to both corporations and individuals is designed to recapture certain tax preference items when they are used to make substantial reductions in what would otherwise be taxable income. The Administration proposes to repeal this minimum tax for corporations and institute a new minimum tax which would raise $4.6 billion in FY 1984. This proposal would have an effect on financial institutions similar to provisions of Revenue Ruling 80-55, which disallowed deductions on interest paid by banks on state and local time deposits secured by tax-exempt obligations.

(2) Industrial Revenue Bonds: The Administration proposes restrictions on tax exempt bonds used to finance private activities. These restrictions would be imposed by:

(a) disallowing accelerated depreciation on facilities financed with tax exempt securities, which would eliminate their attractiveness for many corporations;

(b) requiring government legislative bodies to approve issuance of new bonds;

(c) after 1985, requiring a state or local government financial contribution in any project to be financed with tax exempts; and

(d) prohibiting the use of IDBs to finance biomass, solid waste, small-scale hydroelectric projects, or other energy properties.

These steps would sharply reduce the amount of tax exempt financing of private enterprises through small issue industrial development bonds and pollution control bonds. Some state officials would view such a step as eliminating a valuable development tool. Others would view these moves as freeing the municipal bond market from corporate issues. These and other revenue bonds have grown to over half of tax exempt borrowing, thereby reducing tax exempt interest rates for borrowing for such purposes as construction of schools and roads.

(3) Arbitrage: Issuers of bonds for such purposes as supporting student loans, constructing or renovating hospitals, or purchasing home mortgages have received revenue through "arbitrage", i.e., they have invested the bond proceeds at higher interest rates than they themselves were paying. The Administration proposes to limit such arbitrage to 1/8 of a percentage point.

(4) Mortgage Revenue Bonds: The Administration has not recommended the continuation of mortgage revenue bonds beyond their expiration date of December 31, 1983.

The Administration has included an analysis of tax expenditures for tax exempt debt as a part of its credit analysis. This analysis is summarized in Table 7.

Table 7: Tax Exempt Financing
($ billions)

	FY 1976	FY 1981	FY 1983
Normal State and Local Government (e.g., schools and roads)	$26.4	$28.0	$29.2
Private Purpose Tax-Exempts (e.g., housing, private hospitals, pollution control for business, industrial revenue bonds)	8.5	25.7	40.2
Present Value for New Issues Borrower Benefit	3.8	11.5	19.0
Federal Tax Loss	11.2	20.5	25.9

Table 7 shows the rapid growth in private purpose tax exempt financing, which now exceeds the use of tax exempt borrowing for normal governmental functions. Because it cannot tax interest on new bonds issued in FY 1983, Treasury calculates that it will lose $25.9 billion of revenues on a present value basis (which translates a stream of losses over the bonds' terms into a single FY 1983 estimate by discounting), compared to a borrower benefit from lower interest rates of $19 billion. The difference, nearly $7 billion in FY 1983, is estimated to be the benefit from tax reduction for persons buying the bonds that is not passed along to the borrower.

Grants to State and Local Governments

OVERVIEW

This section discusses the general dimensions of the President's FY 1983 budget proposals for grants-in-aid.[1] Detailed program-by-program discussions of impact are contained in the Program Analysis section of this report.

The FY 1983 federal budget assumes additional reductions in grants-in-aid. In the short term, this is shown most vividly by proposed budget authority, which reflects appropriations, rather than by outlays, which reflect the "spend out" of past appropriations as well as spending of new authority. Table 8 shows the budget authority recommendations of the Administration for grants to state and local governments.

Table 8: Budget Authority for Grants
($ billions)

	FY 1981	FY 1982	FY 1983	Percent Change FY 1981-83	Percent Change FY 1982-83
Total Grants	$105.8	$78.3	$65.2	-38.4%	-16.7%

The reductions are even more substantial when inflation is taken into account. In general, programs which the Administration supports for full funding (e.g., Community Development Block Grants and General Revenue Sharing) are not adjusted to reflect inflation. Other programs are cut in absolute dollar terms, which means their purchasing power is cut twice--once by the budget reduction and once by the effect of inflation. The aggregate results on the grant program totals are shown in Table 9.

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[1] This section follows the grant definitions used in Special Analysis H of the Budget. It thus excludes many items of importance to state governments that are not grants, such as food stamps, purchases of research services from state universities, etc.

Table 9: Grant Allocations in Relation to Purchasing Power
($ billions)

	Budget Authority	Outlays
FY 1981 Actual	$105.8	$ 94.8
Amount Required in FY 1983 to Maintain FY 1981 Purchasing Power[2]	122.7	110.0
Amount In Administration Budget, FY 1983	65.2	81.4
Administration Recommendation as Percent of Amount Required to Maintain FY 1981 Purchasing Power of Grants, FY 1983	53%	74%
FY 1982 Estimated	78.3	91.2
Amount Required in FY 1983 to Maintain FY 1982 Purchasing Power[2]	83.7	97.6
Administration Recommendation as Percent of Amount Required to Maintain FY 1982 Purchasing Power of Grants, FY 1983	78%	83%

Table 9 gives an idea of the overall effect of federal budget changes on activities financed by grants. The costs of providing grant-financed services rise every year for many programs, reflecting increases in the costs of supplies and staff. In some cases, such as Medicaid, costs may increase at a faster rate than inflation generally. In other programs, such as AFDC, cost increases can be held below the rate of inflation with a resulting real reduction of grantees' standard of living. With FY 1981 as a base (a year little affected by the Administration philosophy), grants in FY 1983 will have only 53% (authority) or 74% (outlays) of the purchasing power needed to

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[2] Inflation rates used in this calculation are 16% for FY 1981-83 and 7% for FY 1982-83. Interpolation of calendar year rates to fiscal years gives a range for FY 1981-83 of 15.2% (Administration) to 17% (Congressional Budget Office). For FY 1982-83 the range is from 6.3% (Administration) to 7.6% (CBO).

maintain constant program levels. Viewed another way, this is a cut of 47% in purchasing power in two years for authority and 26% for outlays.

These reductions in purchasing power are sizable enough to have a major effect on state and local governments, private providers of services paid for with grants, and the recipients of services. How the losses are likely to be shared among these groups depends both upon the nature of individual cuts and the programs in which they are made.

As was the case with the FY 1982 cuts, it is likely that a substantial percentage of these cuts will be "passed through" state and local governments, so that the ultimate effects will fall upon service recipients. Other program cuts, such as outlay reductions in capital and construction programs (e.g., transit, waste water treatment, and highways) will have the short term effect of slowing the pace of capital acquisition, with attendant effects on jobs in the private sector and service availability, but with little immediate impact on the solvency of state and local governments. Over the longer term, however, pressures will build to provide state and local funds to finance the needed construction at inflated costs.

Other cuts will have a more substantial and direct effect on the finances of state and local governments. In the case of Medicaid, the Administration proposes two kinds of reductions: (1) reductions in total program costs which should adversely affect providers and recipients, but not state and local governments, and (2) shifts of cost from the federal to the state and local levels.

Under the Administration plan, the FY 1983 reductions are a step along the road to the transfer of federal responsibilities for programs now financed by grants. While the Administration has not yet formulated the details of its "swap" and "turnback" proposals, the substance of the plan is clear. State and local government would begin the plan based upon the reduced FY 1983 levels and, by the end of an eight-year transition period, would have full responsibility for funding many programs now supported by grants with no federal revenues provided for those programs.

As shown in Table 9, both budget authority and outlays for grants will drop sharply if the President's proposals are adopted by Congress.

Budget Authority by Function: Table 10 shows the budget authority for grants proposed by major functions of federal assistance.

Table 10: Budget Authority for Grants by Function
($ billions)

Function	FY 1981	FY 1982	FY 1983	Percent Change FY 1981-83
Income Security	$ 36.4	$16.6	$12.7	-65%
Education, Training, Employment, and Social Services	19.9	14.1	11.2	-44%
Health	19.3	19.6	15.1	-22%
Transportation	14.3	12.5	11.6	-19%
General Purpose Fiscal Assistance	6.1	6.3	6.5	+ 7%
Community and Regional Development	5.5	4.6	4.4	-20%
Natural Resources and Environment	2.5	3.1	3.0	+20%
Agriculture	.8	.9	.4	-46%
Energy	.4	.06	.004	-99%
All Others (Defense, Commerce and Housing Credit, Veterans, Justice, and General Government)	.4	.4	.3	-24%
TOTAL	$105.8	$78.3	$65.2	-38%

The largest reduction is shown in the energy category, where grant programs are essentially all proposed for elimination. The income security function shows the second largest percentage cuts, primarily because of recommendations on low-income housing. If outlay, rather than authority, figures are used, income security is one of the more stable functions in grant funding. On an outlay basis, the reductions are greatest in the education, training, employment, and social service category.

Importance of Grants in State-Local Finance: Table 11 shows the relative importance of grant programs in the context of state and local finance and of the federal budget.

Table 11: Grants in Relation to Total Budgets[3]

Federal Fiscal Year	Grants as Percentage of Federal Outlays	Grants as Percentage of State/Local Budgets
1965	9.2	15.3
1970	12.3	19.2
1975	15.4	23.0
1980	15.9	26.3
1981	14.4	25.3
1983	10.7	18.3
1985	9.6	16.1

Table 11 shows an impressive correspondence between the numbers shown for FY 1985 and those shown for FY 1965. In effect, the Administration recommendations, if accepted by the Congress, would turn back the clock in state-local-federal financial relationships to about where it was in 1965.

Geographic Distribution of Grants: In its special grants analysis, OMB concludes that differentials among states (state and local assistance combined) in federal grant receipts appear to be diminishing, with high population states gaining on low population Western states (with high highway and shared revenue grants) because of the expansion of social programs.

BLOCK GRANTS

The Administration has included eight new block grant initiatives in its FY 1983 budget, including a food and nutrition block grant for the U.S. Territories. Revisions are proposed for three of the blocks enacted in 1981, and six of the 1981 consolidations are continued.[4]

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[3] Data on projected federal outlays, past outlays, and percentages are taken from OMB projections in Table H-6 of Special Analysis H. State and local budgets for FY 1983 and FY 1985 were not estimated by OMB. Estimates of these budgets were made from the implicit OMB FY 1981 estimates by applying a 9% growth factor through FY 1983 and an 8% factor thereafter.

[4] See Summary for grouping of the block grants into "new," "revised," and "continued" block grants. In Table 12, continued blocks are listed first, followed by revised blocks and new proposals.

As Table 12 shows, funding reductions for the blocks between FY 1982 and FY 1983 range from 71.3% to 0%; overall, the blocks were reduced 15.7% since last year.

Table 12: FY 1983 Block Grant Proposals
($ millions)

	Budget Authority			Percentage Change	
	FY 1981	FY 1982	FY 1983	FY 1981-83	FY 1982-83
Social Services	2,991.0	2,400.0	1,974.1	-34.0%	-17.7%
ADAMHA	548.6	432.1	432.0	-21.3%	- 0 -
Preventive Health	99.2	81.6	81.6	-17.7%	- 0 -
Community Services	472.7	348.0	100.0	-78.8%	-71.3%
Community Development	3,695.0	3,456.0	3,456.0	- 6.5%	- 0 -
Education (Chap. 2 ECIA)	521.8	470.7	433.0	-17.0%	- 8.0%
Low Income Energy Assistance	1,905.0	1,807.2	1,300.0	-31.8%	-28.1%
(Including Emergency Assistance)	(55.0)	(55.2)	--		
Primary Care (Including migrant health, black lung clinics, and family planning)	535.0	414.8	416.8	-22.1%	+ 0.5%
Services for Women, Infants, and Children (Including MCH and WIC programs)	1,384.5	1,281.6	1,000.0	-27.8%	-22.0%
Child Welfare (Including Child Welfare Services, Foster Care, Adoption Assistance, and CW Training programs)	522.9	465.1	380.1	-27.3%	-18.3%

(continued on next page)

Table 12: FY 1983 Block Grant Proposals (continued)
($ millions)

	Budget Authority			Percentage Change	
	FY 1981	FY 1982	FY 1983	FY 1981-83	FY 1982-83
Combined Welfare Administration	2,125.0	2,296.0	2,181.0	+ 2.6%	- 5.0%
Vocational and Adult Education	774.5	732.5	500.0	-35.4%	-31.7%
Education for the Handicapped	1,025.2	1,042.1	846.0	-17.5%	-18.8%
Training and Employment	6,095.0	2,25.20	1,800.0	-70.5%	-20.1%
Rehabilitation Services	923.7	925.0	623.5	-32.5%	-32.6%
Rental Rehabilitation Grants [5]	--	--	150.0	N/A	N/A
TOTAL	23,619.1	18,404.7	15,524.1	-34.3%	-15.7%

GRANTS BY TYPES OF AID

Although the Administration budget proposes a reduction in overall grants-in-aid to state and local governments, it reverses an historical trend toward categorical grant programs. Even without considering the Administration's federalism initiatives, the FY 1983 budget--like the FY 1982 budget--continues to advocate the expansion of broad-based grants to states and localities. Table 13 illustrates the proposed outlays for general purpose, broad-based, and other grants.

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[5] Historical data not available. Program to be funded from Rehabilitation Loan Fund and portion of Section 8 (Moderate Rehabilitation) program. FY 1983 figure not included in totals.

Table 13: Outlays by Type of Federal Grant
($ millions)

Type of Grant	FY 1981	FY 1982	FY 1983	FY 1984	FY 1985
General Purpose	6,848	6,483	6,729	6,798	7,104
Broad-based	10,034	12,329	13,929	15,705	15,686
Other	77,880	72,408	60,760	59,350	60,727

As "other" grants are reduced, broad-based and general purpose grants are expected to increase slightly. As a result, the percentage of the decreasing total of grants-in-aid accounted for by general purpose and broad-based grants is expected to grow. Table 14 depicts this change in direction:

Table 14: Percentage of Total Grants by Type of Federal Aid

Type of Grant	FY 1981	FY 1982	FY 1983	FY 1984	FY 1985
General Purpose	7.2	7.1	8.3	8.3	8.5
Broad-based	10.6	13.5	17.1	19.2	18.8
Other	82.2	79.4	74.6	72.5	72.7

Despite considerable growth in broad-based grants, because of the categorical nature of most income transfer and health programs administered by the states, the "other" category remains by far the largest component of federal grants-in-aid to states and localities.

CAPITAL INFRASTRUCTURE

In the FY 1983 budget, as in the FY 1982 budget, reductions in capital expenditures constitute a major element of the Administration program to reduce federal outlays. Three of the principal capital programs supported by the federal government of concern to states are those for highways, water resources, and pollution control and abatement. In each of these areas, major reductions in the federal expenditures are proposed. Federal aid for highways will be reduced another $458 million below FY 1982 levels. FY 1982 expenditures were reduced $500 million from FY 1981 levels. Thus, in a period of 24 months, federal expenditures on highways will drop over $1 billion. Equally important are the specific programs that will be cut. The Interstate Highway System, which constitutes 1% of roads but carries over 20% of all highway transport, is deteriorating badly. Yet, the Administration program would reduce reconstruction and repair activities on this system. Also, aid to urban highways would be reduced almost by half of FY 1981 levels.

The federal expenditures on water resources would be reduced 17% overall --from $4.1 billion in FY 1982 to $3.4 billion in FY 1983. At the same time federal expenditures on pollution control and abatement would be reduced over 14% in FY 1983 from FY 1982 levels ($4.6 billion in FY 1983 versus $5.4 billion in FY 1982).

Table 15: Key Capital Expenditures as Proposed in the
FY 1983 Budget of the United States Government
($ millions)

Capital Improvement Activity	1981 Actual	1982 Estimate	1983 Estimate
Federal-Aid Highways			
Interstate construction	(3,677)	(3,500)	(3,400)
Interstate 4R[a]	(249)	(650)	(600)
Primary	(1,752)	(1,500)	(1,500)
Rural and small urban	(456)	(350)	(300)
Urbanized areas	(892)	(500)	(450)
Bridge construction	(938)	(900)	(850)
Safety	(400)	(200)	(200)
Other	(611)	(600)	(500)
Federal Aid-Highways Total	8,975	8,200	7,800
Total program level[b]	9,105	8,565	8,108
Water Resources			
Department of Agriculture	234	227	170
Department of Defense - Civil Projects	3,222	3,054	2,798
Department of the Interior	804	866	948
Total program level[c]	4,215	4,106	3,407
Pollution Control and Abatement			
Department of Agriculture	2	11	12
Department of Transportation	23	17	12
Environmental Protection Agency	5,156	5,390	4,641
Total program level[c]	5,169	5,384	4,613

Source: Executive Office of the President, Office of Management and Budget, Budget of the United States Government, Washington, D.C., 1982.

a. 4R is the reconstruction of the Interstate Highway System program.

b. Totals include small programs and the net of miscellaneous receipts and disbursements not shown separately. All figures are obligation amounts.

c. Totals include small programs and the net of miscellaneous receipts and disbursements not shown separately. All figures are outlay amounts.

STATE FISCAL CONDITION: A CONTEXT FOR FEDERAL GRANT-IN-AID PROPOSALS

With their revenues buffeted by the national recession, the majority of states entered 1982 either projecting deficits or teetering on the brink of deficit.

In the past, a year-end balance equal to 5% of annual spending was considered a prudent cushion. According to a recent survey, 30 states expect to conclude their current fiscal year in the red or with a balance below 1%[6].

These states are in all parts of the country: New England: Connecticut, Massachusetts, New Hampshire, Rhode Island, Vermont. Middle Atlantic: New Jersey, New York, Pennsylvania. Great Lakes: Indiana, Michigan, Ohio, Wisconsin. Plains: Minnesota. Southeast: Alabama, Arkansas, Florida, Georgia, Kentucky, Mississippi, North Carolina, South Carolina, West Virginia. Southwest: Arizona. Rocky Mountain: Colorado, Idaho, Utah. Far West: California, Oregon, Washington, and Alaska.

Nine other states forecast balances of 1-5%, and only seven predict surpluses of more than 10%. Most of the states with large balances derive substantial revenue from their energy industries.

Many of these budgets are fairly austere. Spending is budgeted to increase 10% or less in 27 states; 8% or less in 19 states. But states are suffering from sluggish revenue growth. During the twelve months ending in June 1981, state tax revenue rose less than 9% and the situation is not likely to be much, if at all, better during the current fiscal year, although more than half of all states raised taxes during 1981 legislative sessions.

Another sign of fiscal hard times is the large number of states reporting that revenue is falling short of projections. With most states reporting only through October, 21 states indicated that revenue was below official forecasts, while only 10 indicated it exceeded the forecast. Since the recession worsened significantly after October, the situation appears even more difficult now. For example, Wisconsin had originally responded to the survey that it expected a surplus of more than $53 million. But in late January legislative and executive estimates of the deficit for the current biennium ranged from $377 million to $450 million.

Among the other states with serious budget problems are Washington, Minnesota, Ohio, Oregon, Michigan, Kentucky, Massachusetts, and California. Nearly all of them have already cut their 1982 budgets sharply, raised taxes, or both.

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[6] The survey was taken by NCSL; it updates similar research conducted by NGA earlier in 1981.

32.

MANAGEMENT IMPLICATIONS OF THE FY 1983 BUDGET FOR STATES

In general, the 1983 budget reduces funding of grants-in-aid to states and references a long-range swap of Medicaid for food stamps and AFDC. Under the President's federalism initiative, a total of 125 programs are being proposed for return to the states. Other items of interest include management initiatives designed mainly to reduce the federal payroll, dismantle the departments of education and energy; reduce federal paperwork; reduce waste, fraud and abuse; and reduce federal publications, government travel and consulting services. New block grants are proposed in eight areas.

These proposals, taken together with the FY 1982 block grants, have a number of management implications for states, including the following:

- Continuing problems will be caused by short lead time provided to implement federal budget reductions and block grants at the state level.
- Many narrow categorical programs will remain in effect, requiring federal efforts to limit restrictive mandates in federal programs and provide for certification of state management systems to meet federal requirements.
- With the many reductions in state and local aid, states will be faced with increased responsibilities in the coordination of budget and management initiatives with local government.
- With the implementation of block grants and prospective elimination of some federal programs, greater state emphasis will be needed on analysis of client groups and targeting of resources to individuals and areas of greatest need.
- With continuing cuts in existing and recently enacted block grants and elimination of state "capacity building" programs, state policy development and management functions may need greater support from state funds.

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Federal Loan and Credit Programs

The federal government provides credit (such as direct loans, full loan guarantees and partial guarantees) through a number of different programs. Some of these programs are "on budget." Outlays for them are reflected in the budget totals, net of repayments, and are covered in the functional narratives in the budget document and, for programs of interest to state and local government, in this report. Other credit programs are "off budget." Spending for them is not included in the budget totals, although information on them is provided in the budget documents. For the last several years, the federal government has adopted a "credit budget" which provides an overview of the federal impact on the credit market as a basis for setting ceilings in appropriation bills on annual extensions of credit.

The Reagan Administration has worked to hold down federal lending activities. Mechanisms have included restricting access to credit by redefining eligibility (e.g., requiring a means test for student loans) and increasing the interest rate on fees charged to borrowers. As a result of these steps and others, the net outlays for direct lending programs are expected to drop from $26 billion in FY 1981 to $21 billion in FY 1982 and $14 billion in FY 1983. This level of net outlays will result in an increase of outstanding direct loans to about $220 billion at the end of FY 1983.

Government loan guarantees are also being restricted in many programs, although total guarantees are expected to continue to increase largely as a result of the major housing loan guarantee programs of the Veterans' Administration and the Federal Housing Administration. Total credit advanced by the federal government in FY 1983 (credit advanced by certain government enterprises, direct loans, and guaranteed loans) will be $114 billion, a $1 billion decline from the amount advanced in FY 1982.

The Administration's budget also calculates the value of interest subsidies implicit in federal direct loan and selected loan guarantee programs. This amount, for newly committed loans, is expected to drop from $17 billion in FY 1981 to $14 billion in FY 1983.

The Administration's legislative program includes proposals for tightening credit available through the guaranteed student loan program, mortgage insurance programs, and disaster loans. Major changes in the Farmers Home Administration, Export Import Bank, and Small Business Administration programs were made in 1981 as part of the Omnibus Budget Reconciliation Act of 1981.

Most federal credit programs affect state and local governments only indirectly, as through the impact of student loans on enrollment in state universities and the need for scholarship programs. Programs affected by tightened credit in FY 1983 which are of particular interest to state officials, besides student loans, include low-rent public housing loans, Farmers Home Administration loan programs, and reductions in the lending programs of the Rural Electrification Administration and the Small Business Administration.

Administration Response to State Concerns

The FY 1983 budget policy of the National Conference of State Legislatures was adopted on December 11 at the meeting of the NCSL State-Federal Assembly. The National Governors' Association policy was adopted at the Governors' 1981 winter meeting and amplified by a letter approved by the NGA Executive Committee on December 4.

This section lists the coinciding policy positions of the two organizations and describes the Administration response.

1. <u>Flexibility in the grant system should be increased through the consolidation of additional programs into block grants and through the elimination of strings and mandates imposed on the block grants already enacted.</u>

If the President's proposals are adopted by Congress, general purpose and broad-based grants will account for 25.4% of grant-in-aid outlays, up from 20.6% the previous year.

The Administration has included eight new blocks in the FY 1983 budget and has revised three of the consolidations enacted last year. As Table 12 shows, funding reductions for the blocks total 15.7% overall between FY 1982 and FY 1983, in addition to reductions of 13.2% in FY 1982 in the consolidations enacted last year, and far less flexibility than the President and state officials sought.

Pending final action on sorting out, NCSL has proposed that Congress allow individual states to participate in "megablock grant" experiments. Under this demonstration program, states would receive approximately the same amount as they did under the categoricals, but they would be able to use their allocations with maximum flexibility to accomplish purposes most appropriately financed with federal funds (e.g. income maintenance, employment, medical assistance). The President makes no specific mention of this concept in his FY 1983 budget, although the megablocks are similar in concept to the first phase of operation of the program trade-off in his federalism proposal.

2. <u>Government has a responsibility to protect the poor, the disadantaged and the handicapped through its policy decisions.</u>

NCSL policy states that "those, who through no fault of their own, must depend on the rest of us--the children, the poverty stricken, the disabled, the elderly, and those with true need--should be assured that the programs they depend on are exempt from federal budget cuts."

NGA policy states that "federal budget reductions must not result in imposing an unfair and disproportionate burden upon the poor, the disadvantaged and the handicapped."

Budget authority figures provided in the President's budget for the two functional areas where most of the programs to aid the poor are contained are as follows:

Table 13: Functional Totals
($ billions)

Function	FY 1981 (actual)	FY 1982 (estimate)	FY 1983 (estimate)	%Change 1982-1983
Education, training, employment, social services	$30.6	$23.5	$18.8	-20%
Income Security	249.9	252.3	257.6	+2.1%
(Social Security)	(133.0)	(150.1)	(168.6)	+12.3%
(Federal employee retirement and disability)	(28.5)	(33.2)	(34.7)	+4.5%
(Other)	(88.5)	(69.0)	(54.3)	-21.3%

In addition, to social security and federal retirement programs, the income security function contains housing assistance, food and nutrition programs, aid to families with dependent children, refugee assistance, and energy assistance. The cuts shown in Table 13 will fall heavily on many of the nation's most needy citizens.

3. <u>The federal government should take steps to "sort out" roles and responsibilities in the intergovermental system. The federal government should move toward primary federal responsibility for income maintenance and medical assistance while state and local governments move toward primary responsibility for such fields as education, transportation and law enforcement.</u>

Although federal expenditures for medical programs are growing rapidly, the FY 1983 budget proposes substantial cuts from current law in the non-health income security programs. As Table 1 indicates, outlays for Social Security, Medicare, and Medicaid are growing as a percentage of the federal budget; spending for all other entitlements (e.g., food stamps, AFDC, child nutrition) is shrinking in relation to the total budget. Table 13 demonstrates reductions in social services and income security programs.

The budget proposes FY 1983 cuts in food stamps, Medicaid, and nutrition programs of $5.7 billion. Some of these would result in a shift to the states of a greater share of the income security burden (e.g., the proposed error rate limitations in entitlement programs and the reduced federal matching rates in Medicaid).

Regarding the other side of the trade envisioned in NGA and NCSL policy, the FY 1983 budget assumes that states will take on increased responsibility for education, transportation, and law enforcement. For grants in these areas, the President proposes the following:

- Budget authority for education grants to states is projected to decline 20% between FY 1981 and FY 1982 and another 19% between FY 1982 and FY 1983. Twenty-eight education grants are proposed to be returned to the states as part of the trade portion of the federalism initiative.

- Budget authority for transportation programs would decline 12.5% between FY 1981 and FY 1982 and 7.6% between FY 1982 and FY 1983. The federal aid highway programs (except the interstate system), the airport grants, and the mass transit operating subsidies and construction programs are included in the federalism initiative trade.

- Budget authority for law enforcement grants-in-aid declines 17.7% between FY 1981 and FY 1982 and 66% between FY 1982 and FY 1983.

In addition to the areas of education, transportation, and law enforcement --in which NGA and NCSL policy both note that states should assume a greater role in a sorting out context--NCSL policy calls for return of library and fire protection programs to the states. New budget authority for both library and fire protection programs not recommended.

Outside the context of the FY 1983 budget, the President has proposed a federalism initiative described in the section which follows. The proposal is consistent with a number of objectives that the states believe are essential for a successful reform initiative, such as an increased federal role in Medicaid, a transition period, equity in state-by-state impact, and a simplified grant-in-aid system.

It is difficult to fit the Administration proposal into the policy framework adopted by NGA and NCSL. It calls for full federal assumption of Medicaid--clearly consistent with the primary responsibility called for in the policy of NGA and NCSL. However, the two organizations have never considered the option of moving the food stamp program from the federal government to the states, nor have they considered full state assumption of the AFDC program. In fact, NGA policy calls for resisting "any attempts to shift Medicaid or AFDC to the state level, in any way, through block grants or otherwise." NCSL policy calls for complete return of responsibilities in one area at a time (consistent with, for example, the notion of a one-time federal takeover of Medicaid) but states that "program areas such as income security,where a predominant federal role seems appropriate, would seem to be the least likely candidates for revenue turnback proposals."

To determine the relationship of the President's proposal to NGA and NCSL policy, the following issues must also be clarified:

- the exact nature of the federalized medical assistance program;
- the maintenance of effort requirement placed on states for income maintenance; and
- the equity and duration of the resource turnback element of the federalism proposal.

4. <u>In an effort to move toward a balanced federal budget, defense, indexed entitlements and tax expenditures must be closely scrutinized.</u>

While the budget as a whole is constrained and some domestic programs are cut sharply, real defense obligational authority is increased by 13.2% in FY 1983 and outlays will increase, in real terms, by 10.5%. Over the FY 1981-1984 period, defense outlays will grow at an average annual rate of 16.5%.

Tax expenditures for individuals were not reduced. While the Administration reportedly considered curtailing tax expenditures for individuals (e.g., ending the deduction of interest on consumer debt, setting a ceiling on the deductibility of employer contributions for health insurance), the final decision was to reject any proposal that could be construed as a tax increase for individuals. Tax expenditures for corporations were reviewed, with the result that collections will be speeded up, a new minimum tax will be established and certain technical changes (e.g., contract completion method of accounting) will be made that increase revenues. Better enforcement measures, plus witholding of interest and dividends, are expected to raise additional tax revenues from individuals and business without any changes in tax rates.

In indexed entitlements, the proposals of the Administration are mixed. The Social Security program was untouched. However, reductions are planned in federal employee retirement programs and in other programs such as Railroad Retirement. Veterans entitlement programs will be little affected by the budget recommendations. For the needs-tested entitlements (SSI and food stamps) program reductions more than offset the projected impact of cost of living indexing. The budget reduces direct federal entitlements by 2.2% from current law and state-federal entitlements by 11.7%.

5. Federal revenue policy should not preempt taxes which have been regarded as tax sources of state and local governments.

The President did not support raising excise taxes, as he was widely reported to be considering. (Excise tax revenues constitute about one-eighth of state tax receipts.) Instead the President proposed gradually turning the federal excise tax base over to the states as part of his federalism initiative.

6. State governments must have sufficient lead time to adjust their own laws, budgets, and administrative procedures to major changes in federal funding or policy.

The President's federalism intiative recognizes this principle and incorporates an extensive transition period (FY 1984 to FY 1991) during which major transfers of responsibilities take place. However, the FY 1983 budget contains many administrative changes (such as in the entitlement programs) and funding reductions (such as in the block grants) without transition time.

Federalism Proposal in the State of the Union Address

On January 26, President Reagan announced a major federalism initiative, designed to take effect in FY 1984. The details of the proposal are now being negotiated with state and local officials. In his speech, the President described the initiative as follows:

- The "swap" component would involve federal absorption of $19.1 billion in state Medicaid expenditures and state absorption of $16.5 billion in federal AFDC and food stamp costs. These are FY 1984 numbers and assume implementation of $4.1 billion in additional cuts in the AFDC and food stamp programs in FY 1982 and FY 1983.

- The "turnback" component would involve the return of 125 grant programs (sometimes grouped into 43 program areas) amounting to $30.2 billion in FY 1984. About $6 billion in FY 1983 cuts are assumed.

- A federalism trust fund of $28 billion would finance the program turnback and equalize gains and losses among states caused by the swap. Of the $28 billion fund, $16.7 billion would come from the windfall profits tax and the remaining $11.3 billion would come from federal excise taxes on gasoline, tobacco, alcohol, and telephone service.

- Between 1984 and 1987, states could opt to receive the funds they would have gotten under the 125 categorical programs either through the categorical structure or without program restrictions (similar to General Revenue Sharing). This transition period would end in FY 1988, when the categorical grants would be terminated.

- Also beginning in FY 1988, 25% of federal excise taxes would expire each year, and the trust fund also would decline. States would have the options of enacting the same taxes, replacing them with other revenues, or cutting programs.

- States opting to receive funds through the categorical programs must pay related federal administrative costs.

- Aid received by states through the trust fund is subject to local pass-through requirements: 100% of aid that would have been allocated through direct federal-local grants must be passed through; 15% of all other non-education funds would be passed through. The General Revenue Sharing formula would be used to allocate pass-through monies.

- States would be required to maintain basic AFDC and food stamp benefit levels under the swap, but no details have yet been developed.

THE STATE PERSPECTIVE

The President's program recognizes a number of principles that the states have long believed to be essential to a successful federalism reform initiative. These include:

- a greater federal role in the Medicaid program;
- a greater federal role in health care cost containment;
- an extended transition period;
- equity in the state-by-state impact of any proposal; and
- simplification of the current grant-in-aid system.

However, there are a number of issues which must be resolved before the states can take a firm position on the Administration's federalism package.

Issues Relating to the Swap

1. Is the swap consistent with the states' view of the appropriate federal role in the federal system?

   Governors and State Legislators have long held that income security is a federal function because people should have equal protection from want no matter where they live, because the cost of providing assistance is so great that states--with their unequal tax capacities --would find it difficult to support these costs, and because need is determined largely by national economic policy which the states cannot control. Moreover, a national response is required for extraordinary circumstances--such as very high unemployment in a particular sector, or a natural disaster-- which drain the ability of the states to support the needs created.

   While the President's proposal incorporates part of the states' position by suggesting a larger federal role in Medicaid, it also assumes reduced federal responsibilities in other important income security programs.

2. Are the calculations of relative federal and state gain/loss under the "swap" based on figures agreed to by the states?

   The President's proposal is based on the assumption that state contributions to the Medicaid program will grow to $19.1 billion in FY 1984, a level consistent with state projections. However, the proposal assumes that the federal share of the food stamp and AFDC programs will be just $16.5 billion, or $4.1 billion less than the amount that the preliminary Congressional Budget Office figures show will be necessary to maintain the current programs in FY 1984. According to the CBO projections, therefore, instead of being a trade favorable to the states by $2.6 billion in the first year, it is unfavorable by $1.5 billion.

The Administration has assumed 5.8% real growth in Medicaid between FY 1984 and FY 1991 (as compared to a 6.3% rate between FY 1978 and FY 1982) with an annual inflation rate of 4% and unemployment a constant 5.5%. The President's proposal has valued the AFDC/food stamp program at no real growth (as compared to 8.8% between FY 1978 and FY 1982). Thus, all of what would have been the state share of these expected cost increases for Medicaid are considered savings and are added to the resources available to the states to take over additional program responsibilities as the trust fund expires. Similarly, the reduced costs projected by the Administration for the AFDC and food stamp programs are counted as savings to the states.

3. <u>What are the federal plans for the Medicaid program?</u>

The state-by-state differences in the Medicaid program have been widely discussed, and it has been suggested that the federal government would have to level this disparity in a national program. A crucial element of the federalism proposal is how the federal Medicaid program would be designed.

This question is important for all states, but it is vital for the "winners" under the swap because they will be forfeiting their allocations under the trust fund to offset their gains in the trade. If the Medicaid program is substantially curtailed (e.g., only basic services are covered, or only welfare recipients are covered), then the "winning" states will be pressured to fund both supplements to the Medicaid program and activities formerly supported by categorical grants with the same dollars. They become losers under these circumstances.

4. <u>What federal requirements will be placed on states in connection with the turnback to them of food stamp and AFDC responsibilities?</u>

Specifically:

- The proposal suggests that the states will be required to meet "flexible maintenance of benefit requirements." Does this apply to both current and potential recipients and will it require a minimum benefit or the maintenance of existing benefits in even the highest benefit states?

- Will future reductions in the remaining federal income security programs, such as veterans assistance and housing, force states to substantially increase state costs to maintain the current minimum level of AFDC benefits?

- How will the states be assisted to meet unusually high income security costs that may result from the impact of federal policy on trade and the economy as a whole?

Issues Relating to the Turnback

1. Does the gradual reduction and phase out of the trust fund by FY 1991 provide for equity in funding in relation to state need?

The formulas under which funds for many of the programs now on the turnback list are distributed use some measure of need to determine state allocations. By using the average of the years FY 1979, 1980 and 1981, the proposal locks in the needs based distribution for twelve years. One issue to decide is whether some flexibility should be developed, perhaps through use of a portion of the trust fund aimed at areas of greatest service need or of lowest tax capacity. The nation's demographics indicate that many changes will take place over the twelve years between 1979 and 1991.

2. Are the revenues sources being turned back appropriate for use by states to fund the programs included in the turnback?

The trust fund, which phases out completely in FY 1991, contains two revenue sources: federal excise taxes and the crude oil windfall profits tax. Excise taxes do not keep pace with inflation and thus are commensurate with the rate of growth of grant-in-aid programs only if the programs decline in real dollars over time. Excise taxes, like sales taxes, also place a relatively heavier burden on lower income households. The state-by-state consumption patterns of these goods are largely unrelated to the need for the services. The exception is the motor fuel excise tax (two cents to be returned) which is directly related to the non-interstate highway programs.

The crude oil windfall profits tax is directed at oil producers. It cannot necessarily be assumed by states when the trust fund phases down because the majority of the oil production occurs in five states. Only 23 states have any production capacity whatsoever. Moreover, the structure of this tax originally was a "profit" tax, which was not designed to be passed on to consumers. Thus there would not necessarily be a price decrease by the producers when the federal tax expired. If the windfall profits tax were converted to an excise tax on motor fuel, consumers would be paying 14¢ more per gallon of gas.

3. <u>Is the size of the trust fund adequate to support the responsibilities returned to the states?</u>

While the FY 1984 numbers appear to make the "swap" less attractive to states, rapid increases in health care costs compared to other programs may make the exchange of Medicaid for AFDC and food stamps more palatable in the out-years. Weighed against this consideration, however, is the unknown rate of growth in the food stamp program, which is highly responsive to economic conditions.

The Administration has proposed that $28 billion in federal revenues be traded for $30.2 billion in programs. However, an OMB spokesman has indicated that the FY 1982 funding for the 125 programs involved was $35.2 billion. Administration officials have said that the trust fund will be expanded to reflect the spending levels set by Congress for programs turned back.

4. <u>Are the programs to be turned back appropriate responsibilities for states as opposed to the federal government?</u>

At the present time, it is the position of state officials that they are willing to assume primary responsibility for programs in the areas of education, transportation, and law enforcement. Hundreds of small categorical grants remain in the intergovernmental system after the proposed turnback, and some of these may be better candidates for state responsibility than those initially suggested by the Administration.

5. <u>Does the proposal adequately protect both state and local governments?</u>

The list of programs proposed for turnback contains a number of major direct federal-local grants such as General Revenue Sharing, the community development block grant program, and the urban development action grant program. In these cases, the proposal requires a complete pass through of program funds during the four year transition phase. For other non-education programs whose funds are grouped into the turnback, there is a requirement that 15% be passed through to local governments, regardless of whether the funds have traditionally gone to states.

Congressional Outlook

In the FY 1982 budget, President Reagan attracted support for his reductions from both his own party and a significant number of Democrats, in part with the promise of a balanced budget by FY 1984. For FY 1983, most observers feel that Congress will be unwilling to adopt the substantial cuts proposed in light of continued steep defense increases and annual budget deficits of nearly $100 billion.

A key issue shaping congressional action on the FY 1983 budget will be whether there is economic recovery by May or June when the first votes are scheduled. Some observers believe that uncertainty about the economy and election year pressures may delay meaningful action on the budget, perhaps even until a lame duck session.

The success of last year's budget reductions was due to the use of the reconciliation process, which forced a single vote in each chamber on a wide range of program cuts. That technique will be more difficult to use this year because many members -- committee chairmen in particular -- consider this process too sweeping. Rep. Jim Jones (D-OK), chairman of the House Budget Committee, has said that some members believe the process was abused last year, and that it will take time to regain confidence in it. Individual votes on a list of cutbacks such as those contained in the President's budget would diminish the likelihood of achieving them.

This is an election year, and outside of the 14 members who have announced they will not run, all House members face election. The current balance of 242 Democrats and 192 Republicans (1 vacant) requires Democratic support for any successful effort. The so- called "Boll Weevils," conservative Southern Democrats, were an important force in fashioning the President's bi-partisan victory last year. Today they are openly concerned about the deficit -- most would like to see it at $50 billion or lower -- and some have reservations about the size of the tax cut and/or the increase in defense spending.

The other significant House faction in last year's budget effort was the "Gypsy Moths," northeastern and midwestern Republicans whose states were sharply affected by the budget cuts. The proposed FY 1983 reductions, which include entitlements, will be difficult to support in their heavily populated urban areas which are among the hardest hit by the recession. The proposed defense increases generally have the least impact in their states.

In the Senate, where the President's party holds a 6 vote edge (53-47), 33 seats are up for reelection; 20 of these are currently Democratic, 12 Republican, and 1 Independent. Majority leader Howard Baker (R-TN) urged the President as recently as December to raise taxes and lower defense spending increases. Senator Paul Laxalt (R-NV), who is a close friend of the President and the chairman of the Presidential Federalism Advisory Committee, expressed concern following the FY 1982 budget cuts that states may have already been handed too much.

REVENUE PROPOSALS

House Ways & Means Chairman Daniel Rostenkowski (D-IL) has stated that he intends to keep the problem of the economy on the Administration's doorstep, and that while he can envisage a small revenue enhancement measure, he expects to let the Republican Senate write any major tax bill that might be necessary to reduce the deficit. The Ways & Means Committee has discussed attacking the controversial "leasing" provisions of the Economic Recovery Tax Act of 1981 as well as some of the oil industry breaks included in that bill.

Senator Dole, who has already expressed concern over the deficit, has agreed that any further tax increases in an election year will be difficult without the President's backing. Several of the President's initiatives have been proposed in the past without success, such as withholding on interest and dividends. The minimum corporate income tax and the completed contract accounting proposals will also encounter stiff opposition but may fare better.

PROGRAM REDUCTIONS

The Administration has asked Congress for major cuts in two of its favorite federal aid programs--education and transportation--to the tune of $4 billion. It is unlikely that Congress will go along with these suggestions at the same time it is being asked to approve a $32 billion spending increase for the Department of Defense.

Other programs appealing to the Hill that are targeted for cuts -- energy assistance, legal services, rental housing construction, and Older Americans Act programs--may be reduced, but by significantly lower amounts than have been proposed. Other programs will undergo serious scrutiny and could see substantial reductions. Among these programs are arts and humanities, urban parks, coastal zone management, historic preservation and water resource planning.

AGENCY REORGANIZATION

While there is a broad public impression that implementation of the President's plan to eliminate the Departments of Energy and Education is just a matter of time, it would be premature to assume that this campaign pledge will soon be realized. Both departments are relatively new, and a number of their sponsors are still in pivotal positions in Congress. These members--both Republican and Democrats--are not likely to sit back and watch their handiwork be undone. There is also the question of the impact on committee structures should these departments be dissolved. Reorganizations are not priority items on the Congressional calendar and could become submerged in the budget struggle yet to come.

responsibility and not enough funding to support it. He has called the proposed deficits "numbing". Senator Robert Dole (R-KS), chairman of the Senate Finance Committee, has said the Republican members have told him that they are concerned about the high deficit figures and believe that defense spending is not off-limits for budget savings. Senate Budget Committee Chairman Pete Domenici (R-NM) has been working for the last few months on a proposal to slow the size of the defense increases, curb entitlement program growth, and close tax loopholes to gain additional revenues needed to make a balanced budget possible. Senator Ernest Hollings (D-SC), ranking minority member of the Senate Budget Committee, is developing a budget alternative that would freeze spending for benefit programs and military spending and delay the 10% income tax rate reduction due in July. His proposal projects a $40 billion deficit.

The following are brief comments on the major FY 1983 budget proposals in the context of the congressional climate.

BLOCK GRANTS

Last year the President proposed consolidating 85 categorical programs into 6 block grants. Congress approved working 57 programs into 9 block grants. The President also proposed more sweeping state flexibility in the programs than the Congress allowed. Final action on the FY 1983 proposals may not be much different. Several of this year's block grant candidates have strong special interest support in Washington, especially the handicapped and rehabilitation programs.

The new block grants are proposed for inclusion in the turnback portion of the President's federalism initiative. Congressional decisions on the block grants may provide insight on the future of the initiative.

ENTITLEMENTS

While it is not yet clear how Congress will react to specific funding reductions for entitlement programs that are administered by state governments, most members of Congress in this election year will be looking at how deeply the cuts will slice into their constituents' benefits. There probably will be sufficient congressional support to tighten regulations and restrict eligibility for a number of these programs. But Congress will likely resist deep cuts in Medicaid, child nutrition, student aid, and food stamps.

These entitlements also have strong Hill sponsors who will resist further reductions in programs that serve needy and poor working citizens. What might be seriously considered even though there would be substantial opposition is the curtailing of cost of living adjustments in government pension, disability, and retirement programs.

Program Analysis

Agriculture

AGRICULTURE RESEARCH AND EXTENSION

The federal agricultural research program involves both "in-house" (USDA) spending and funding for land-grant, 1890 and other institutions. Emphasis in research will be placed on animal and plant production and soil and water conservation, key elements to sustaining agricultural production in future years.

FY 1983 Budget Proposal: Spending for general agricultural research will increase by $24 million to $455 million, and cooperative state research outlays will rise $2 million to $229 million. Proposed Extension Service spending will decline by $2 million to $308 million.

Impact on the States: While spending for agricultural research will increase in actual dollars, inflation will actually lead to lower program levels. Pressures will arise for increased spending in both land-grant research and extension activities.

Outlook: In relative terms agricultural research and extension have done well. Nevertheless, the budget proposal does not represent progress in areas that have demonstrated a high return on investment.

EXPORT PROGRAMS

Federal agricultural export programs involve market development activities, export financing and humanitarian relief. Emphasis will continue in market development and credit guarantees (as opposed to direct loans), but a small decline in the Public Law 480 "Food for Peace" program is proposed.

FY 1983 Budget Proposal: Spending for export market development will increase by $4 million to $40 million, and export credit guarantees will remain at $2.5 billion. Outlays for P.L. 480 will drop by $113 million to just over $1.0 billion.

Impact on the States: These budget adjustments will have little impact on the states.

Outlook: Pressure has been increasing for direct export loans to stimulate demand for wheat and feed grains. Direct loans under similar programs in the past have meant outlays in excess of $2 billion. Congressional concern will develop regarding a 200,000 metric ton drop in grain purchases for the P.L. 480 program.

SOIL CONSERVATION

The federal soil conservation programs involve the activities of local soil and water conservation districts, cost-share activities with agricultural producers, and technical assistance through the Soil Conservation Service to individual landowners. In recent years, many experts have contended that soil erosion could become one of the most serious environmental issues of the 1980s and that efforts to arrest erosion would have a direct relationship to the supply of food and fiber for future generations.

FY 1983 Budget Proposal: The Department of Agriculture is asking for a new $10 million matching grant pilot program to state and local governments. Spending for conservation operations under the Soil Conservation Service will increase by $34 million to $341 million. The Administration also proposes a $74 million reduction in watershed construction funding as well as a $164 million cut in funds for the cost-share program to farmers and ranchers. Termination of the Resource Conservation and Development Program is also proposed for FY 1983. The budget also includes a proposal to combine funding for the Agricultural Conservation Program (ACP), emergency conservation, forestry incentives and water bank program (cost-share programs to producers) with funding reduced to 25 percent of the FY 1982 level.

Impact on the States: The new pilot program would involve outlays of $8 million in FY 1983. A USDA analysis projects that such a program could cost $105 million in future years if fully funded. Budget documents indicate that the Administration anticipates that landowners and state and local governments would increase their funding of conservation programs as farm income improves and federal taxes are reduced.

Outlook: The severe reduction in cost-share programs will result in increased attention to spending for the new pilot program. In recent years, various Administrations have tried to curb spending for cost-share programs, efforts that met with little success.

ANIMAL AND PLANT HEALTH INSPECTION

Federal and state governments have a cooperative program designed to assure the safety of the food supply.

FY 1983 Budget Proposal: Programs involving state-federal eradication efforts are recommended to be reduced by $50 million in FY 1983. These include reductions in brucellosis eradication ($31 million), gypsy moth ($4.5 million), imported fire ant ($3.[illegible] million), and elimination of the golden nematode ($1 million), witchweed ($4.7 million), and scabies programs ($1 million).

<u>Impact on the States:</u> Program reductions could result in considerable increases in spending if absorbed by the states. Generally, each program involves individual states or small number of states.

<u>Outlook:</u> It is difficult to project whether Congress will agree with such reductions. In the past, several of these eradication programs have been recommended at reduced spending levels by various administrations, but Congress has eventually appropriated more funds.

Community and Economic Development

HOUSING OVERVIEW

The proposed rescission of $9.4 billion in budget authority for FY 1982 and $2.4 billion in FY 1983 for Annual Contributions for Assisted Housing, a rental rehabilitation block grant proposal, a shift to modified Section 8 certificates (better known as "vouchers") and the inclusion of food stamps for the purposes of determining low-income tenants' annual income are highlights of HUD's FY 1983 budget. No new housing budget authority is being requested.

Because of a change in the method of accounting for HUD programs, proposed activity levels reflect gross authority incorporating any recovered or recaptured (and therefore unused) authority from prior years as well as proposed new authority. HUD had previously used a net basis of accounting which only reflected proposed new authority for its programs. Under this new system, HUD will propose to operate its programs with a budget authority request of only $684 million for FY 1983. In comparison, HUD's total FY 1981 budget authority was $33.4 billion and is proposed to drop in FY 1982 to $13.0 billion after the $9.4 rescission noted above. This dramatic drop is accounted for by the elimination of federal subsidies for all new rental housing construction (except for the elderly and handicapped), and a shift to housing vouchers, a cash payment of $2,000 per year to low-income families who would seek housing in the private market. HUD also proposes creation of a rental rehabilitation block grant combining funds from the Section 8 moderate rehabilitation program and Section 312 rehabilitation loans. This assistance would be provided to states and localities to cover 50% of the cost of either multi- or single-family rehabilitation projects, with 50% match provided by the developer. No outlays are projected for the program in FY 1983, but some $150 million in budget authority is provided.

These and other program changes such as the elimination of mortgage subsidy bonds constitute a major revision in the federal role in rental housing construction and will have dramatic affects on both state and local housing authorities. Changes in the determination of tenants' annual income could also affect other state-administered income security programs. (FmHA [Farmers Home Administration] rural housing programs can be found below, under Rural Development.)

Housing Programs

The Section 8 housing assistance payments program is being drastically restructured under the FY 1983 budget proposal. This program, originally enacted as part of the Housing and Community Development Act of 1974, provides housing assistance payments to low-income families and has been HUD's major housing assistance program since its enactment. Families are required to pay 30% of their incomes toward rent (increased in FY 1982 from 25%) with rent supplement payments provided to landlords or housing authorities in amounts which equal the difference between this 30% of tenant income and the so-called "fair market rent" for a given unit.

The Section 8 program encompassed three basic types of rental units: those newly constructed or substantially rehabilitated, those needing moderate rehabilitation, and existing units suitable for occupancy. In FY 1982, approximately 45% of the funds provided for Section 8 housing were used for new construction or substantial rehabilitation and 55% for moderate rehabilitation or existing units. For FY 1981, 184,131 units of Section 8 housing were approved with a budget authority of $19.4 billion.

FY 1983 Budget Proposal: The Section 8 program in FY 1983 would essentially be dismantled and reconstituted into two new programs with all new construction and substantial rehabilitation programs eliminated. HUD will propose for a FY 1982 a $9.4 billion rescission of all new construction funds and an FY 1983 rescission of $2.4 billion. The magnitude of these rescissions and the ability to rescind FY 1983 funds not yet appropriated is possible because of carryover budget authority from prior years. Only 10,000 units of Section 202 housing for the elderly and handicapped and 5,000 units already legally committed will be proposed in the new construction and substantial rehabilitation categories. The remaining 106,615 families would be assisted through "Modified Section 8 Certificates" more commonly known as vouchers. These vouchers would average $2,000 per year and be granted to tenants and remain constant for five years. The current Section 8 existing program that the vouchers most closely resemble grant certificates to landlords for up to 15-year periods. Existing Section 8 commitments by HUD to local and state housing authorities would be gradually converted to vouchers as contracts come up for renewal, leaving some doubt as to whether any additional low-income families would be able to be served under the voucher program. Tenants would be responsible for finding suitable housing units and would be allowed either to supplement the voucher if their rent exceeded it or retain the cash difference if their rent were less.

The other new initiative would convert the Section 8 moderate rehabilitation program in combination with the Section 312 rehabilitation loan program into a new rental rehabilitation block grant. Budget authority of $150 million is provided in FY 1983, but no outlays are expected for the program until FY 1984. Under the proposal, grants would be made to states and localities on an as yet unspecified basis to subsidize rehabilitation of rental units on a 50-50 cost sharing basis with private developers.

A significant legislative proposal for FY 1983 will be the inclusion of the value of food stamps in determining tenant income. Section 8 eligibility is now 80% of the median income (adjusted geographically and for family size) with aid targeted primarily to tenants with 50% of the median income. Under this proposal, the amount which equaled 30% of a tenant's income would rise substantially if the tenant remained eligible for the housing program.

Impact on the States: The direct impact on state governments of these changes is two-fold: (1) the need for food stamp information by both state and local public housing authorities would complicate the administration of state and local housing programs, and (2) the proposals do nothing to stimulate the production of housing for low-income families. Although the vouchers may prove to be an improvement over the now expensive Section 8 program, they will not provide production assistance in areas with low vacancy rates. It is doubtful whether the $2,000 per year would be adequate, particularly in later years, as the subsidy remains constant while rents increase. States may also feel pressure from local governments to provide greater state assistance as the massive federal withdrawal of housing assistance occurs.

State housing finance agencies in particular will be hit by the withdrawal of federal aid, the inability to issue mortgage revenue bonds, and the changes in the amount of arbitrage an issuing agency is allowed to earn on reserves for any private purpose bond including multi-family housing bonds. This combination could affect these agencies' ability to carry out their basic missions as well as their dependence on directly appropriated state funds.

Outlook: A proposal of this magnitude may have difficulty in Congress although there is general agreement on the need for reform in the Section 8 program. It is acknowledged to be expensive on a per unit basis and among the fastest growing of the income security programs. Rescissions of $9.4 billion in FY 1982, however, will not substantially reduce outlays immediately. Outlays for housing payments will increase from $6.73 billion in FY 1982 to $7.35 billion FY 1983. The proposal to include food stamp income may also face opposition and will have to first be acted upon by the Agriculture committees.

ECONOMIC DEVELOPMENT

All Economic Development Administration Assistance Programs have been eliminated in FY 1983. Non-highway Appalachian Regional Commission programs have been recommended for termination. Title V Regional Commissions are not revived.

Economic Development Administration (EDA) Assistance Programs
The EDA provides public works grants, economic development planning grants, technical assistance, and direct business development loans and guarantees to assist economically distressed areas.

FY 1983 Budget Proposal: EDA planning grants, technical assistance grants, development grants and economic adjustment grants have all been eliminated in the Administration's FY 1983 budget request. Thus, the FY 1982 budget level of $198 million in budget authority would be decreased to $0 in FY 1983.

Impact on the States: Much of the impact of the termination of the program will be felt at the local level.

Outlook: The Administration's request to terminate the EDA program has been anticipated at the state, local and congressional levels. It seems unlikely that EDA will survive this attempt to kill it. New authorization legislation may be proposed in Congress, but it will not likely be identical to the existing program.

Minority Business Development
The Minority Business Development Agency (MBDA) of the Department of Commerce coordinates federal minority business development programs. The Minority Business Development program includes enterprise development, policy and market development, information dissemination and research. The Minority Business Development program would be funded at the level of $50.0 million in budget authority in FY 1983, a decrease of $6.6 million from the FY 1982 level. The MBDA management and technical assistance program would be restructured to focus attention on the development of private sector market opportunities for minority businesses.

Title V Regional Commissions
The elimination of the Title V Regional Commissions that began in FY 1982 would be completed in FY 1983. No new appropriation is requested for these entities in FY 1983.

Appalachian Regional Commission (ARC)
The ARC provided funds to a 13-state area for regional development. No FY 1983 funds are requested for the ARC non-highway projects. However, the Administration is requesting $80 million under the Federal Highway Administration budget for ARC highway projects in FY 1983. Beginning in FY 1987, all new construction for the Appalachian Development Highway System is to be funded from the 13 states' available apportionments under the Department of Transportation's federal highway aid program.

National Consumer Cooperative Bank
The Bank, which once received a federal appropriation, has been self-financed out of Bank earnings since 1981. The Bank makes loans and provides services to consumer and other types of cooperatives.

Small Business Loan and Investment Fund
The Small Business Administration (SBA) through the Business Loan and Investment Fund makes loans to small businesses that are unable to obtain private financing. The Administration requests $143.7 million in FY 1983 to provide additional capital to carry out authorized functions of the fund. The SBA will initiate a bad debt collection program to increase loan repayment to a significant degree over the normal amortization schedule for prior and current fiscal years.

Enterprise Zones
The Administration proposes to submit legislation calling for the designation of up to 25 zones each year for three years to experiment with the free market approach for dealing with urban problems. No budget authority is requested for the program but a set of federal tax expenditures is proposed. These tax incentives, designed to increase investment and employment, will be provided for up to 20 years to businesses and individuals locating in these areas.

FY 1983 Budget Proposal: The Enterprise Zone proposal will require the enactment of legislation, not yet submitted to Congress. Start-up time for the program will take all of FY 1983. Therefore, the tax incentives are not expected to be reflected as a reduction in federal tax receipts until FY 1984. At that time, the Administration anticipates that federal tax receipts will be reduced by $310 million, and by $620 million in FY 1985.

Impact on the States: To be designated as an enterprise zone, localities in conjunction with their states must be selected in a national competition based on the level of tax and regulatory relief, opportunities for neighborhood involvement and improvement in public services, possibly through turning over the provision of some of those services to private enterprise. It is not possible to estimate the impact on the states until the Administration's legislative proposal is made available.

Outlook: There is considerable Congressional and state interest in the proposal, but it is too early to predict whether any finally enacted bill will resemble the Administration's concept. If the proposal contains anticipated controversial items such as sub-minimum wages for teenagers, major opposition to the bill is certain.

Other Tax Expenditures
Changes relating to industrial development bonds and arbitrage restrictions are detailed in the Overview section entitled The Economics of the Program.

BUDGET AUTHORITY FOR SELECTED
ECONOMIC DEVELOPMENT PROGRAMS
FY 1982 and FY 1983
($ millions)

	FY 1982 BA	FY 1933 BA
Economic Development Administration (EDA) Planning Grants:		
a. Districts and Counties	$15.0	$ 0
b. States and Territories	2.9	0
c. Indian	3.0	0
d. Urban	4.6	0
Subtotal	25.5	0
EDA Technical Assistance Grants	9.5	0
EDA Development Grants	130.0	0
EDA Economic Adjustment Grants	33.0	0
Total EDA Assistance Programs	198.0	0
MBDA Minority Business Development	56.6	50.0
Title V Regional Commissions	0	0
Appalachian Regional Commission		
Highway Projects	109.9	80.0 *
Non-highway Programs	72.6	4.0 **
Total ARC	150.0	0

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* Funded through Highway Trust Funds
** Close out activities transferred to other agencies.

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BUDGET AUTHORITY FOR SELECTED
ECONOMIC DEVELOPMENT PROGRAMS
FY 1982 and FY 1983
($ millions)

	Admin.* Comt.	BA	O	Admin.* Comt.	BA	O
SBA Business Loan & Investment Fund	$692.0	$326.0	$359.0	$551.5	$143.7	$129.9

* Administrative Commitments (the amount of business loans approved)

COMMUNITY DEVELOPMENT

The Administration's FY 1983 budget includes proposed budget authority of $3.46 billion for Community Development Block Grants (CDBG) and $440 million for Urban Development Action Grants (UDAG). The Urban Homesteading Program budget request is $12 million. The Neighborhood Reinvestment Corporation would be funded at $15.5 million. (Rental Rehabilitation Grants targeted for $150 million are described under the Housing section of this analysis. Community development programs for rural areas are described in the Rural Development section.)

Community Development Block Grant (CDBG)
The CDBG budget request of $3.46 billion for FY 1983 is the same budget level as FY 1982, but outlays are expected to drop by $655 million. The non-entitlement state Community Development Block Grant program would continue at the FY 1982 level of $1.02 billion. The Community Development Block Grant program is one of the 44 programs to be included in the President's FY 1984 federalism initiative.

Urban Development Action Grants (UDAG)
The major focus of the UDAG program is the use of federal funds to leverage private investment in distressed cities and urban counties. The Administration is recommending $440 million in budget authority, the same as for the current fiscal year, with estimated outlays of $550 million. UDAG is also one of the 44 programs to be turned back to the states in FY 1984 as part of the President's federalism initiative.

Urban Homesteading
The budget proposes an appropriation of $12 million for FY 1983. Of that, $9 million would be used to support an estimated 818 single-family properties to be transferred from Department of Housing and Urban Development ownership to units of general local government for use in an urban homesteading program, a program of homeownership intended to encourage public and private investment in selected neighborhoods and to assist in their preservation and revitalization. The Administration plans to use $3 million to support the transfer of a minimum of 15 multifamily buildings, a demonstration program that will require authorizing legislation. The FY 1982 program was financed from FY 1979 carryover funds.

Rental Rehabilitation Grants
This program is covered under the Housing section.

Neighborhood Reinvestment Corporation
The Corporation supports neighborhood housing services programs and neighborhood preservation projects. Budget authority for the Corporation increases from $13.9 million in FY 1982 to $15.5 million in FY 1983.

65.

BUDGET AUTHORITY AND OUTLAYS FOR SELECTED COMMUNITY DEVELOPMENT PROGRAMS FY 1982 and FY 1983
($ millions)

	FY 1982		FY 1983	
	BA	O	BA	O
Community Development Grants	$3,456.0	$4,005.0	$3,456.0	$3,350.0
Entitlement	2,379.7		2,379.7	
Non-Entitlement	1,019.9		1,019.9	
Urban Development Actions Grants	440.1	525.0	440.0	550.0
Urban Homesteading	-0-	20.0	12.0	12.0
Rental Rehabilitation Grants	-0-	-0-	150.0	-0-
Neighborhood Reinvestment Corporation	13.9	13.9	15.5	15.5

Rural Community Development

The federal government's direct activities to promote rural development include four major types of programs:

grants for community facilities; grants for rural water and waste disposal systems; loans for water, and community facilities; and loans and grants for rural housing.

In the aggregate, the Administration's budget projects a modest increase in both budget authority and outlays for the overall function of rural development:

Budget Authority and Outlays for Rural Development Programs
($ Millions)

FY 1981		FY 1982		FY 1983	
BA	OUTLAYS	BA	OUTLAYS	BA	OUTLAYS
$701	$839	$585	$1,066	$754	$1,217

These budget authority and outlay increases do not reflect an increase in program commitment, however. Rather, they reflect the FY 1983 costs of previous commitments. In fact, the Administration proposes a severe cutback in both loans and grants for rural community development in FY 1983:

RURAL COMMUNITY DEVELOPMENT PROGRAMS

($ Millions)

	1981	1982	1983	FY 1982-1983 % CHANGE
Loans:				
Water and waste disposal	$ 750.0	$ 375.0	$300.0	-20.0%
Community facility	260.0	130.0	130.0	---
Business and industrial (B&I)	652.3	300.0	---	-100.0%
Alcohol production facility	---	250.0	---	-100.0%
Total, loans	$1,662.3	$1,055.0	$430.0	-59.2%
Grants:				
Rural water and water disposal	210.0	125.0	120.0	-4.0%
Business and industrial (B&I)	5.0	---	---	---
Rural community fire protection	3.5	3.2	---	-100.0%
Total, grants	218.5	128.2	120.0	-6.4%
Total, Rural Development Development Program Level	$1,880.0	$1,183.2	550.0	-53.5%

The dramatic decline in loans for rural community development reflects the Administration commitment to reduce the federal credit budget substantially. Overall, loan program reductions in the Farmer's Home Administration will amount to $2.6 billion in direct loans to farmers and rural communities and $600 million in loan guarantees. Slated for total elimination are business and industrial loans and grants, alcohol production facility loans and rural fire protection grants.

Rural Housing

Through the Farmer's Home Administration, the federal government assists the development of rural housing, primarily in very small communities. Rural housing loan programs will decline significantly if Administration budget proposals are implemented.

RURAL HOUSING PROGRAMS
($ Millions)

	1981	1982	1983	FY 1982-1983 % CHANGE
Rural Housing Loan:				
Very Low-Income Housing Repair loans (sec. 504) (subsidized)	$ 17.9	$ 24.0	$ 24.0	---
Low-Income Housing Loans (Sec. 502) (subsidized)	2,327.5	2,300.0	900.0	-60.9%
(unsubsidized)	4.7	---	---	---
Domestic Farm Labor Housing loans (Sec. 514) (subsidized)	18.5	25.6	19.0	-25.8%
Rental or Cooperative loans (Sec. 515) (subsidized)	842.5	940.0	200.0	-78.7%
(unsubsidized)	22.3	---	---	---
Moderate Income Housing loans (Sec. 502)(unsubsidized)	251.3	429.0	---	-100.0%
Above Moderate Income Housing loans (Sec. 502) Guarantees	5.7	---	---	---
Site Loans (Sec. 524) (unsubsidized)	.5	5.0	2.0	-60.0%
Self-Help Housing Land Development Fund (subsidized)	.5	2.0	---	-100.0%
Weatherization Loans (Sec. 502) (unsubsidized)	1.7	1.0	---	-100.0%
Total, Rural Housing Loans	3,493.1	3,726.6	1,145.0	-69.3%

Grants for rural housing will also be substantially reduced by nearly 24% from $32.8 million in FY 1982 to $25.0 million in FY 1983. Rural rental assistance subsidies will be decreased by 53.5%, falling from $398.0 million in FY 1982 to $185.0 million in FY 1983.

Combining both loans and grants, total rural housing programs will decline from $4.2 billion in FY 1982 to $1.4 billion in FY 1983, a 67.4 percent decrease.

Arguing that "rural areas generally are adequately served by private credit markets," the Administration justifies these deep cuts in Farmers Home Administration housing programs as part of "a general effort to limit the growth of federal outlays and to reduce the dependence on the federal government as a supplier of credit."

CULTURAL RESOURCES

National Foundation on the Arts and the Humanities

The Administration is proposing a decrease of 39% from $276 million in FY 1982 to $198 million in FY 1983 in the overall budget authority for the National Endowment for the Arts (NEA) programs and the National Endowment for the Humanities (NEH) programs.

Budget authority for NEA programs (excluding administration) would decrease from $133 million in FY 1982 to $88 million in FY 1983. A similar decrease from $121 million to $85 million is recommended for NEH. State grant programs, which represent approximately 16% of the NEA and NEH program funding levels, are cut proportionately.

Historic Preservation

The Administration is recommending a $25 million reduction in budget authority for the Historic Preservation Fund, thereby eliminating the program in FY 1983. The program provided matching grants to states for planning and individual preservation projects.

Urban Park and Recreation Fund

The Administration is recommending an $8 million reduction in budget authority for the matching grant program to cities for renovation of urban park and recreation facilities, thereby eliminating the program in FY 1983. This program is treated similarly to the state grants for parks under the Land and Water Conservation Fund. The Administration says it is leaving to state and local governments decisions concerning acquisition and development of their own parks and other recreational resources.

BUDGET AUTHORITY FOR SELECTED CULTURAL RESOURCES PROGRAMS
FY 1982 and FY 1983
(S millions)

	FY 1982 BA	FY 1983 BA
National Endowment for the Arts		
Total Program (Excluding administration)	$133,285	$88,275
State Grants	21,286	14,528
National Endowment for the Humanities		
Total Program (Excluding administration)	121,078	84,760
State Grants	20,329	13,200
Historic Preservation Fund Total	25,440	-0-
State Grants	24,876	-0-
Urban Park and Recreation Fund	7,680	-0-

Education

DEPARTMENT OF EDUCATION

The FY 1983 federal education budget is based on the assumption that a Foundation for Education Assistance headed by a presidentially-appointed director will be established by the Congress to replace the U.S. Department of Education. The budget, therefore, reflects the reduction from 149 programs to 66 programs to be administered by the foundation, including the consolidation of some 32 existing programs, termination of 23 programs and the transfer of 28 programs to seven other agencies. It would also include the abolishment of regional offices for "representation" and "dissemination", and the elimination of 11 boards and commissions, including the Intergovernmental Advisory Council on Education.

The major remaining programs and functions of the Foundation would be:

- Block grants and consolidated aid for states and local education agencies, including programs to be turned back in the federalism initiative;
- Core services for information, research and statistics;
- Postsecondary student financial aid;
- Compensatory programs for the disadvantaged, the handicapped and others; and
- Civil rights complaint investigations, compliance reviews and negotiations for voluntary compliance.

There would be a transfer of 28 programs and subprograms to other agencies:

- Six in Rehabilitation to HHS;
- Three in Intergovernmental Education to the International Communications Agency;
- Five in Indian Education to Interior;
- Three under Special Institutions to HHS;

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- Five under Impact Aid to Treasury, one to Defense;
- Three under College Construction to Treasury;
- One under Minority Institutions to NSF;
- Institute of Museum Services to Arts & Humanities;
- Architectural and Transporation Barriers Compliance Board to Transportation; and
- Impacted aid, section 6, to Defense.

In addition, civil rights enforcement responsibilities would be transferred to the Department of Justice.

The U.S. Department of Education was created in 1979 during the Carter Administration. It was seen by its proponents as a way of raising the national awareness of the importance of education, pulling together in a more efficient central agency many of the educational programs scattered throughout the federal bureaucracy, and improving intergovernmental and constituent access and communication.

Opponents of a Cabinet-level agency argued that it would result in increased federal intrusion into state and local primacy in education policy, increased administrative and regulatory burdens, and distorted state and local priorities. President Reagan took the latter position and promised in his electoral campaign to dismantle the new Education Department.

<u>FY 1983 Budget Proposal:</u> (Note: Most federal education grants are forward-funded by one year. FY 1983 funds will be used in school year 1983-1984.)

Requested budget authority for Department of Education programs is 10.0 billion for FY 1983. This is a decrease of $2.9 billion, or 22.5%, from the revised FY 1982 request level of $12.9 billion, authority of $13.0 billion in the continuing resolution. The FY 1982 figures include an authorization of $1.7 billion for programs proposed for transfer to other agencies should the Congress approve replacing the Department of Education with a foundation, as proposed. A funding authority of $1.2 billion is being requested for the transferable programs for FY 1983, which if deducted from the $10.0 billion total request, would leave an $8.8 billion authorization request for the proposed foundation.

Total outlays for a foundation would decrease by 2.0 billion, or 13.8% from current Department outlays, although $500 million in net outlay supplementals are expected to be sought to finish FY 1982. Current outlays are set at $14.5 billion. Revised FY 1982 outlays would be $15 billion. Projected outlays for FY 1983 would be $12.5 billion. If the foundation concept is approved, FY 1983 outlays for the foundation would decrease to $11.4 billion due to program transfers to other agencies. It is difficult to determine what the budget might look like if the Congress does not approve the replacement of the Department with a foundation. It could be assumed, however, that many of the programs proposed for transfer or elimination may remain in an on-going Department, if at reduced levels. A standby budget is being readied should the Congress not accept the foundation proposal.

Impact on the States: Cumulative outlay reductions in federal education funding are projected at about $2.5 billion dollars for the next fiscal year. This comes at a time when states are already reeling from the effects of the recession and high unemployment, in addition to last year's federal budget cuts.

Even with states wishing to assert their primacy in education over the federal government, immediate funding reductions of this magnitude will stifle their ability to assume new program responsibilities readily. A more gradual process would be preferred.

Outlook: There is little support in Congress for dismantling the Department of Education at this time. Many in both parties think it a minor issue in the face of major economic problems. They also would like to give the Department more time to prove its worth.

The opinion of state elected officials is mixed on what the nature of a federal education agency should be, other than to prefer a central agency for education rather than dispersal of programs to other agencies.

ELEMENTARY-SECONDARY EDUCATION

Compensatory Education for the Disadvantaged

Chapter 1 of the Education and Improvement Act of 1981 funds this reformed version of the Title I, ESEA programs. The proposal for a Foundation for Education Assistance continues funding support for this effort, although at considerably reduced levels. The FY 1983 program request is $1.94 billion. This represents a 29% reduction from current authorization of $2.74 billion.

The Administration is assuming that, as the general school-age population declines through this decade, local school districts will achieve savings in general education through school closings and employing fewer teachers, some of whom can be used to educate the disadvantaged. It is not clear how states and school districts would make up for a major reduction in funding over the coming year for this unusually successful program, especially in the states that have growing school populations.

FY 1983 Budget Proposal: With currently authorized budget authority in the FY 1982 continuing resolution at $2.74 billion, the

Administration intends to seek rescissions to reduce the current fiscal year authorization to $2.36 billion. Proposed FY 1983 funding would reduce the authorization further to $1.94 billion.

Revised outlays for FY 1982 would be $2.98 billion (for school year 1982-1983), a reduction of 11.0% from FY 1981 levels of $3.35 billion. FY 1983 outlays are scheduled at $2.55 billion, a reduction of nearly $430 million, or 14.4% (flr school year 1983-1984). This represents a two year reduction of 23.9% in outlays. It is anticipated that proposed outlays for this program will continue to decrease to $2.0 billion in FY 1984, and to $1.57 billion in FY 1985.

Impact on the States: The Administration expects local and state education agencies to seek more cost-effective means of delivering compensatory education. This, plus utilizing savings from reduced general education, would make up for projected losses in federal funding. Also program reforms allowing greater control over and flexibility in the use of funds is expected to produce cost saving administrative efficiencies.

Strong political support exists for this program both at the national and state levels. Replacement with state and local dollars will be difficult in light of reduced federal funds in other program areas as well - especially education of the handicapped. Nevertheless, long sought-relief reductions in regulations and mandates may provide the flexibility necessary to offer these programs at less cost.

Outlook: Resistance is building against reducing authorization for this program by $800 million in the coming fiscal year. Studies that show this to be one of the more successful federal education programs lends strength to continued political support. It is doubtful that Congress will reduce the program by this magnitude in an election year.

Chapter 2 (ECIA) - Block Grant

The Education Block Grant was authorized in the Reconciliation Act of 1981 at $589 million. It is comprised of some 29 categorical programs, pulled mostly from the former Elementary and Secondary Education Act (ESEA). The Administration currently proposes including this block grant in the list of programs to be turned back to the states under its federalism initiative. Until then, they propose funding it at reduced levels through FY 1985.

FY 1983 Budget Proposal: The Education Block Grant is authorized in FY 1982 at $483.8 million; recissions are proposed to reduce that figure to $470.4 million. Authorization for FY 1983 is being sought at $432 million, or a reduction of 10.7%, from current levels. Expected outlays for FY 1982 are $666 million, and for FY 1983, $578 million (school years 1982-1983 and 1983-1984). Higher outlay figures are the result of forward-funding and the spend-out of antecedent programs.

Impact on the States: State officials support the block grant concept as a means of receiving federal support to assist states and school districts in serving the educational needs of special populations without burdensome mandates and regulations. In the face of reductions in other major programs, states and school districts look to the education block grant as a source of flexible funds for improving priority programs. Steep reductions in the block grant will place an even greater fiscal burden on many states in attempting to accomplish the educational improvement purposes of the block grant.

Vocational and Adult Education

For FY 1983, the Administration seeks a significant reduction in funding and the enactment of a vocational and adult education consolidation. The consolidation proposal would place the existing categorical programs into a single block grant to the states, with a small amount for discretionary projects in areas of particular national significance. Also, it is intended to simplify or eliminate current requirements regarding state administration, planning, evaluation, fiscal accountability, public participation and reporting of data.

FY 1983 Budget Proposal: Vocational and adult education is currently authorized for FY 1982 at $739.7 million. Expected rescissions are proposed to reduce that figure to $633.9 million. Authorization for the new block grant in FY 1983 is being sought at $500 million, a reduction of $239.7 million, or 32.4% from current policy levels. Total categorical outlays for FY 1982 are expected to come to $1.12 billion. FY 1983 outlays for the new block grant and spend out of forward-funded categoricals are expected to amount to $644 million, a reduction of $476 million, or 42.5%, in outlays.

Impact on the States: The Reagan Administration assumes that because of the approximately 11 to 1 overmatch in state and local funding compared to federal contributions for vocational education, the cutback will have only a marginal impact on delivery of services, and that state and local sources will be able to assume the cost of those services which are most needed. It is also assumed that reduction of paperwork and administrative burdens, as proposed for the new block grant, will enhance state and local government flexibility and permit them to do more with fewer dollars.

Both of these assumptions are generally in line with the consensus of most state selected officials. However, state officials also seek adequate sustained funding of block grants to assure the success of their intentions. A 42.5% reduction in federal outlays will seriously hamper the effectiveness of this program. With new demands for training and retraining, and high levels of unemployment, states will be hard-pressed to improve vocational and adult education systems to meet future technological needs. More comprehensive programs are needed to meet new skilled job demands.

Education for the Handicapped

For FY 1983, the Administration is seeking considerable reductions in funding while proposing enactment of a consolidated special education state grant. The block grant would consolidate Part B State Grants and Preschool Incentive Grants under the Education of the Handicapped Act, and state grants for education of the handicapped funded under Chapter 1 of the Education Consolidation and Improvement Act of 1981 into one state formula grant. This special education state grant is intended to simplify administrative requirements, increase flexibility for state and local governments and reduce the burden on educational agencies, while retaining essential protections for handicapped children provided for in P.L. 94-142. The proposal would seek to reduce regulations and mandates, allowing states and school districts to determine appropriate education levels for handicapped students, and would shift the funding burden for related services to more appropriate social service agencies.

FY 1983 Budget Proposal: Education of the handicapped is currently authorized for FY 1982 at $1.19 billion. Rescissions are proposed to reduce that figure to $899.7 million. Authorization for the new state grants in FY 1983 is being sought at $845.7 million, a reduction of $344.3 million, or 28.9%from current policy levels. Total categorical outlays for FY 1982 (school year 1982-1983) are expected to be $1.27 billion. FY 1983 outlays for the new state special education grant are expected to total $839 million, a reduction of $431 million, or 33.9%

Impact on the States: Few programs have caused as many funding problems for states and local school districts as the education for the handicapped programs. Federal statutes and case law are laden with mandates and regulations which result in heavy compliance costs. Also, political support for these programs is well organized at both state and federal levels. P.L. 94-142 authorized the federal government to pay for up to 40% of excess costs to educate handicapped children. The federal contribution has never exceeded 11.8%, leaving a heavy burden on state and local governments.

State and local officials have long sought relief from these burdensome requirements while supporting the concept of educational opportunity for handicapped children. It also has been general state policy that funding reductions should not be made in these programs as long as the heavy mandates remained. Even with regulatory relief, however, the states are faced with serious fiscal problems due to current economic conditions. These problems will slow the ability of the states to accept new levels of program funding for these programs, especially to the extent proposed.

Bilingual Education

The bilingual education program is proposed to remain in the Foundation for Educational Assistance. Budget authority is to go from $138 million in FY 1982 to $94.5 million in FY 1983—a drop of $43.5 million or 31.5%. District eligibility for basic grants is to be broadened, desegregation grants as such are to be discontinued (although desegregation projects may be eligible for basic grants), training activities will remain as in the past and support services will be consolidated into new Resource Centers.

Impact on the States: Despite a 31.5% cut in funds, the Administration projects only a 10.5% decline in the number of projects and a 16.5% decline in the number of students served in FY 1983 in those states with bilingual education programs.

Research and Statistics

Education research is currently funded through the National Institute of Education and education statistics are collected and processed by the National Center for Educational Statistics. Budget authority for the two functions was $74.5 million in FY 1981, but outlays were only $61 million. In FY 1982, budget authority is $62 million, and outlays are estimated to reach $91 million.

FY 1983 Budget Proposal: The Administration proposal would retain a core of research and statistics activities in the Foundation for Educational Assistance. Outlays for the combined functions are budgeted at $106 million for FY 1983, an increase of $15 million or 16.5%. In FY 1984, they would drop to $68 million and in FY 1985, to $62 million. Budget authority would remain essentially constant at $62 million for FY 1982 through FY 1985. Major emphases in research are to continue to be "issues of excellence and basic skills"--for example, how children can improve their reading and mathematical skills, how teachers can be more effective and how schools can better manage their finances.

Impact on the States: Although outlays will increase from FY 1982 to FY 1983 under the Administration proposal, they will decline thereafter. Budget outlays will remain flat and thus will not keep up with inflation. Effects on the statistical function would probably be a small decline. The research function, which would affect some state research institutions, would drop more significantly after FY 1983.

HIGHER EDUCATION: STUDENT FINANCIAL AID

Federal funding for students with demonstrated financial need experiences a major overhaul in the FY 1983 budget. While the discretionary student aid programs have been squeezed from a $3.7 billion appropriation in FY 1980 to $3.5 billion in FY 1981, to $3.4 billion under the 1982 Continuing Resolution, the FY 1983 Administration budget completely eliminates 3 of the 5 major student aid programs, and funds the remaining at a total of $1.8 billion. Limited federal assistance will remain available in reduced amounts primarily for students at the lowest income levels. Assistance for most students with family incomes in the $14,000 - $25,000 range would be eliminated. Since student federal aid is not part of the federalism agenda, federal dollars are reduced without providing offsetting resources to states and institutions. Since student financial assistance is forward funded, FY 1983 dollars will apply to school year 1983-1984. The programs listed below are analyzed on the basis of budget authority.

Pell Grants
These grants provide financial aid directly to undergraduate students and form the base upon which other financial aid is awarded. Individual student eligibility is determined by a national needs analysis which takes into account the ability of the student's family to contribute to educational costs. The program was established in 1972 to provide students with a minimum level of assistance that could be used at any postsecondary institution and has grown dramatically from its initial appropriation of $122 million.

In FY 1981 (academic year 1981-1982), Congress appropriated $2.346 billion, providing 2.8 million students with grant awards ranging from a minimum of $200 to a maximum award of $1,670; the average award is $838. Pell grants were reduced to $2.279 billion under the Continuing Resolution; this reduction eliminated 400,000 middle-income students (with family incomes of $20,000 - $26,000) from participation in the program.

FY 1982 Rescissions: The Administration proposes a rescission of $91.4 million below the Continuing Resolution levels, reducing Pell grants to $2.188 billion in the 1982-1983 academic year. This would further reduce award recipients by approximately 300,000 students.

FY 1983 Budget Proposal: $1.4 billion is requested, $900 million less than the $2.3 billion allotted under the Continuing Resolution. An estimated 1.8 million students would receive Pell grants, with the maximum grant reduced by $70 to $1,600. Benefits to middle and lower middle income students would be eliminated by increasing the percentage of discretionary income (income remaining after a reserve for basic family expenses is subtracted) which families must contribute to the support of a student.

Impact on the States: The program will be cut by nearly 40% from FY 1981 levels, removing more than one million students from the 2.8

million current award recipients. Assistance would be ended to virtually all students whose families earn more than $14,000 a year. States will have to consider how much access they want to provide for students from families who had been previously eligible for Basic Educational Opportunity Grants (BEOG) awards.

Outlook: It is unlikely that the drastic reductions for Pell grants will be accepted by Congress. The program serves the neediest of the student population. Opposition from students, parents and higher education institutions has been effective in the past. The exact amount of funding for Pell grants (as well as for student aid as a whole) will depend on the total budget adopted by Congress, as well as on decisions on efforts to curtail the costs of Guaranteed Student Loans.

State Student Incentive Grants (SSIGs)
SSIGs were established in 1972 to encourage the creation of state scholarship programs for needy students, through a dollar-for-dollar federal-state match. All states currently participate in the program, and a number considerably overmatch the federal contribution. For academic year 1981-1982, the total state grant pay-out will exceed $900 million, of which only $76.7 million are federal SSIG funds. Awards were provided to 307,000 students this year, averaging $500. The program is funded at $73.7 million under the Continuing Resolution.

1982 Rescissions: A $6.1 million rescission is requested, reducing the program to $67.5 million.

1983 Budget Proposal: The program is completely eliminated under the rationale that the goal of stimulating all states to provide need-based grants to postsecondary students has been met.

Impact on States: While a number of states overmatch the yearly federal SSIG contribution, elimination of this program would place in jeopardy the continued existence of state student aid funding in at least 15 states which have struggled to meet the dollar-for-dollar federal-state match.

Outlook: The program will be extremely difficult to retain. While the House recommended $76.7 million for SSIG in the FY 1982 Labor-HHS-Education Appropriations bill, the Senate recommended no funding for the program. Special language in the Continuing Resolution preventing the elimination of a program which had been cut out in only one House protected SSIG through March 30, 1982. While efforts are being made to find a spokesman for the program during the next appropriations battle, reductions in Pell grants and campus-based aid will also compete for protection.

Campus-Based Programs
In academic year 1981-1982, more than $1.1 billion has been obligated under the three campus-based programs: the College Work Study, the Supplemental Educational Opportunity Grants (SEOGs) and the National Direct Student Loan (NDSL) programs. These funds will assist approximately 1.5 million needy students at 4,300 colleges and universities.

The federal funds are distributed directly to college campuses based on state allocation formulas and are used in the development of student financial aid packages for needy student enrollees. Under the Continuing Resolution, SEOGs are funded at $278.4 million, College Work Study at $528 million, federal capital contributions under NDSL at $178.6 million.

FY 1982 Rescissions: The Administration recommends a $44 million rescission in College Work Study, reducing the program to $484 million. It is estimated that 73,000 of the 990,000 students participating in the program would be forced to leave. These students earn, on an average, approximately $600 to assist in meeting their school expenses.

FY 1983 Budget Proposal: Supplemental Educational Opportunity Grants and federal capital contributions to National Direct Student Loans are both eliminated in the FY 1983 proposal. Only College Work Study remains, at a recommended level of $397.5 million. This is a $130.5 million reduction from the $528 million allotted under the Continuing Resolution.

Impact on the States: Approximately 615,000 students receive SEOG awards, with average awards at $600. Withdrawal of federal funding for capital contributions to NDSL would eliminate awards to 266,000 students. Institutions would be left with only their NDSL revolving funds to make new loans and the size of these funds varies widely among institutions. The elimination of federal funding for these programs, coupled with the reductions in College Work Study, will adversely affect even the poorest student who still qualifies for a Pell grant since little additional federal funding will remain available for him to complete his student financial assistance package. While these cuts directly affect students, states must decide whether to increase state dollars for student aid or to increase aid to institutions to maintain student access to postsecondary education.

Outlook: Restoration of College Work Study program funds is likely because the work element of the program particularly appeals to conservative members. National Direct Student Loans, however, will prove difficult to restore. Even without additional federal capital contributions, repayments on prior-year loans will make $435 million available for NDSL. The high default rates experienced by institutions in the program will make further funding hard to defend. Restoration of SEOG funding will depend on whether Congress wishes to place the majority of funding increases for needy students in Pell grants, or whether funding for SEOG can compete successfully for attention.

HIGHER EDUCATION: GUARANTEED STUDENT LOANS (GSL)

Guaranteed Student Loans, the only entitlement in the student aid portfolio, has grown from $367 million in FY 1977 to $2.5 billion in FY 1981. Loans to 3.5 million students in the amount of $7.8 billion were made in FY 1981. When the GSL program was established in 1976, 26 states had state guarantee agencies. By this Spring, all states are expected to have operational guarantee agencies. The Continuing Resolution only placed \$1.8 billion in the program, with Congress recognizing at that time that additional funding would be required to meet program obligations in FY 1982. Recommendations to curtail GSL growth have been debated over the last few years. The present program provides 9% loans to students with family incomes below \$30,000 and requires that students from families with incomes above \$30,000 demonstrate need. The federal government pays the difference between the average quarterly 91-day Treasury bill rate plus 3.5% and this 9% for the life of the loan. Students pay a one-time 5% origination fee on all new loans and, while a student is in school, the federal government picks up his in-school interest subsidy. The Administration argues that continued "uncontrolled" growth in GSL will squeeze out funding for the majority of discretionary education programs. If no legislative changes are made, FY 1983 costs are projected at \$3.4 billion. (The total education program budget for FY 1983 is \$10.3 billion.)

<u>FY 1982 Rescissions/Supplementals</u>: The Administration will request a FY 1982 supplemental of \$978.2 million, raising the total program cost to \$2.8 billion. This figure is based on enactment of specific legislative changes discussed below. If no changes are made this year, FY 1982 costs are expected to reach \$3.1 billion.

<u>FY 1983 Budget Proposal</u>: Five major legislative changes are proposed, to take effect April 1, 1982:

- doubling the loan origination fee from 5% to 10%;
- requiring an analysis of need for students of all family income levels;
- eliminating graduate students from participating in GSL by requiring these students to borrow only under the new auxilliary loan program at 14%, rather than at the GSL 9% interest rate;
- eliminating special allowances to lenders two years after the borrower leaves school; and
- charging guarantee agencies a new reinsurance premium as well as raising insurance premiums for lenders of federally insured loans.

Savings of \$309 million are expected in FY 1982 and \$912 million in FY 1983.

<u>Impact on the States</u>: Each of the above changes points to greater financial burdens for students and their families. Any instability in the program caused by legislative changes runs the risk of discouraging lender participation. In particular, elimination of the special allowance raises questions regarding lender participation and will force passing increased costs on to students. Further, some 600,000 graduate students--over half of all graduate enrollments--presently depend on GSLs to finance their education. The Auxilliary Loan Program, on which they would be required to depend, is currently operational in only 14 states. The impact of these changes will affect students for the

1982-1983 academic year. Pressure will then be placed on states by students seeking to maintain access to postsecondary education as federal funds are withdrawn.

Outlook: Authorizing committees in Congress will receive increased pressure from their budget committees, particularly in the Senate, to reduce overall GSL costs. Whether the Administration's recommendations are accepted or adapted, reductions in GSL are likely. The question of how and where to reduce program costs remains open.

HIGHER EDUCATION: TITLE III INSTITUTIONAL AID

Title III Institutional Aid provides grants to strengthen institutions serving large numbers of disadvantaged students, especially black colleges. Institutions receiving assistance have considerable flexibility in determining how funds will be used. Funds may provide support services to students, finance outreach efforts or improve the administrative and academic capabilities of the institution. Institutions compete directly for funds. Use of funds must not be inconsistent with state planning. Appropriations in FY 1981 were $120 million; $124.4 million was allotted under the Continuing Resolution.

FY 1982 Rescissions/Supplementals: The Administration requests a $5.2 million increase, raising the program to $129.6 million.

FY 1983 Budget Proposal: $129.6 million is requested; this is the ceiling for the program under the reconciliation act.

Impact on the States: No direct state impact.

Outlook: The program has received congressional support in the past, particularly in the House.

Employment and Training

President Reagan's proposed budget for FY 1983 reflects a forthcoming legislative initiative for a new program of state-level block grants for the administration of training programs previously operated through the prime sponsorship system. Service levels are expected to remain the same as in FY 1982 (about 1.1 million) even though resources for training programs will decrease; the key saving mechanism is the elimination of stipend payments which will not be paid to individuals attending classroom training. Fewer people would be served in FY 1983 as the new program is phased in.

Some nationally-administered programs for groups with particular disadvantages in the labor market will be retained. Among the groups to be served are Native Americans, migrant and seasonal farmworkers, older workers and trade adjustment assistance recipients. There is no specific reference to refugees.

Under the proposed budget, the Job Corps program will experience a reduction in service to 1970s levels. Federally-operated centers will be closed in favor of those run by private contractors.

Other budget highlights include:

- A total phase-out of the Work Incentive Program (WIN) is proposed for the end of 1982, to be supplanted by mandatory workfare of the Community Work Experience Program under the welfare reform proposals.

- The Community Service Employment Program for older workers is scheduled for elimination; older workers will be trained under the nationally administered target programs component of the block grant. (Past programs targeted to older workers did not assume they needed training due to prior labor force experience.)

- Trade Adjustment Assistance is to be eliminated by July 1, 1982 except for persons already in approved training.

- The Targeted Jobs Tax Credit program would expire on December 31, 1982, with no replacement proposed.

- The Summer Youth Employment Program (one of last year's seven safety net programs) is targeted for elimination.

Comprehensive Employment and Training Act
The Comprehensive Employment and Training Act (CETA) of 1973 provides employment and training opportunities for economically disadvantaged youth and adults through a network of prime sponsors, generally state governments and local governmental units with populations over 100,000. Included in the act are the Job Corps, Summer Youth Employment Program and the Private sector Initiatives program, along with the comprehensive training program.

In FY 1981, the Administration phased out the Public Service Employment (PSE) program under CETA, eliminating 340,000 public service slots for public and private non-profit employment opportunities targeted to the long-term unemployed. The remaining CETA authorization is scheduled to expire at the end of FY 1982. Total budget authority for CETA prior to the elimination of PSE was $8.127 billion in FY 1980. Proposed budget authority for FY 1983 is $2.387 billion.

FY 1983 Budget Proposal:

BUDGET AUTHORITY FOR EMPLOYMENT AND TRAINING PROGRAMS
($ millions)

	FY 1982	FY 1983
Block Grant	$ --	$1,800
Title II BC (Comprehensive Services)	1,132	--
Title III (National Programs)	140	--
Title IVA (Youth Employment)	192	--
Title IVC (Summer Youth)	640	--
Title VII (Private Sector Initiatives)	230	--
Special Targeted Programs	--	200
Community Service Employment for Older Americans	67	--
Trade Adjustment Assistance	25	--
Targeted Jobs Tax Credit	20	--
Title IVB (Job Corps)	586	387
Program Support	38	--
TOTAL	$3,070	$2,387*

*Assumes authorization of employment and training block grant legislation.

Community Service Employment for Older Americans

This program provides part-time work opportunities in community service activities for unemployed low-income persons age 55 and over. Budget authority for this program in 1981 was $277.1 million and outlays were $262.8 million. Budget authority in 1982 is $66.5 million, based on the continuing resolution in effect through March 31, and outlays are expected to be $267.7 million.

In FY 1983, this program is slated for elimination under the assumption that new employment and training legislation will serve older workers. One facet of the program would provide additional job training assistance through a nationally-administered program for special segments of the population. The budget authority proposed for this targeted program is $200 million in FY 1983, with outlays estimated at $180 million. Outlays to phase-out the Community Service Employment program are estimated at $6 million.

Other Labor Services (Department of Labor-Bureau of Labor Statistics)

The federal government establishes and enforces standards affecting the relationship between employers and employees and between unions and their members. In addition, employment and unemployment statistics and data on wages, prices and productivity are collected and disseminated. In FY 1983, the Administration proposes to eliminate special statistical work, with budget cuts affecting the Labor Turnover Statistics program, the Occupational Employment Statistics (OES) program, the Lower Living Standard program, and the Price and Productivity Index program, and decreasing the Current Population Survey (CPS) sample size in the 30 largest SMSAs and the 30 smaller states. This will decrease the reliability of statistics used in various state funding allocation formulas.

Work Incentive Program

The Work Incentive Program (WIN) has provided persons receiving AFDC with training, job counseling and labor market services. The Administration is proposing to terminate this program at the end of FY 1982, with outlays of $11 million in FY 1983 for program termination. In its place, the budget assumes enactment of comprehensive social welfare amendments to require states to establish Community Work Experience Programs (CWEP). CWEP would provide able-bodied AFDC recipients with public sector work assignments and require recipients to work enough hours to offset their welfare benefit as calculated at the minimum wage (workfare).

Impact on the States: The funding levels presented in the proposed FY 1983 budget and the anticipated legislative initiative have serious implications for the future of employment and training services:

- drastic reductions in federal assistance for "at risk" populations suggest that the "safety net" at least for summer youth program participants is gone;

- the new employment and training legislative initiative would be targeted solely at welfare recipients and youth, with no provision for dislocated workers;

- older worker employment opportunities would be eliminated, to be replaced by training under the block grant; and

- dislocated workers would no longer receive income maintenance payments, only training assistance.

Outlook: The Administration, in an unreleased legislative proposal, is planning to seek authorization for an employment and training block grant to states for services to only two disadvantaged populations, AFDC recipients and youth. The federal government would retain principal responsibility for services to special target groups, i.e., older workers, Trade Adjustment Assistance recipients, migrant and seasonal farmworkers, and Indians and Native Americans. Sub-state, private sector-dominated service delivery mechanisms are likely vehicles for local planning and administration of employment and training.

The ranking majority and minority members of the congressional subcommittees with jurisdiction over employment and training programs have introduced legislation (jointly in the Senate and separately in the House) for reauthorization of employment and training programs. Unlike the Administration bill, all the congressional legislation assumes a separate authorization and appropriation for displaced workers, a re-write of the Wagner-Peyser Act (Employment Service), an expanded scope of service to cover the educationally and economically disadvantaged populations, and maintenance of a modified version of the Work Incentive Program for AFDC recipients.

Employment and training programs would be turned back to the states under Phase II of the Administration's federalism proposal.

Unemployment Insurance and Employment Services (UI/ES)

States receive the UI/ES Administration grant to cover the administrative costs (i.e., staff, premises, etc.) associated with the Unemployment Insurance (UI) and Employment Service (ES) programs. The primary source of these funds is the Federal Unemployment Tax Act (FUTA) tax paid by employers, with the Employment Service receiving 3% of its funding from general revenue. The only new budget authority required, therefore, is the general revenue amount for the Employment Service. The remainder of the funds are authorized outlays from the Unemployment Trust Fund.

FY 1983 Budget Proposal: The proposed FY 1983 budget for state employment security agency administration of the ES and UI programs is $2.345 billion, of which $2.323 billion is drawn from the Unemployment Trust Fund (FUTA) and $22.2 million from general revenues. The increase in administrative financing results from both the supplemental appropriation request for FY 1982, increasing ES financing, and the agreement to finance ES at a higher level in FY 1983. The total ES positions available will be 24,800 in FY 1982 and approximately 21,000 in FY 1983.

GRANTS TO STATES FOR UNEMPLOYMENT INSURANCE AND EMPLOYMENT SERVICES
($ millions)

	FY 1982	FY 1983
Total Outlays	$2,276	$2,345
Unemployment Insurance Outlays	($1,552)	($1,625)
Employment Service Outlays	(724)	(720)
Revenue Sources	$2,276	$2,345
FUTA Funds	(2,251)	(2,323)
General Revenue	(25)	(22)

Unemployment benefits will be paid to an estimated 11.5 million unemployed workers in 1982 at a cost of $23.2 billion. In FY 1983, 10.5 million workers will receive benefits, costing $21.0 billion. The total unemployment rates implicit in these estimates are 8.9% (4.7% insured unemployment rate) for 1982 and 8.1% (4.5% IUR) for FY 1983. Employer taxes to states and federal trust funds for the payment of extended benefits will be insufficient to meet these benefit outlay figures. Therefore, $4.3 billion will be advanced to the UI Trust Funds from general revenues in 1982. Similarly, in 1983, $4.5 billion will be advanced to the UI Trust Funds for benefit payments.

Impact on the States: Assuming the passage of the FY 1982 supplemental request of $210 million for ES administration, the FY 1983 staff level proposed by the Administration would represent a 15% reduction in ES staff years (3,800 staff years). Such a cut would probably be applied across the board to all states.

Based on current financing schemes, FUTA will run out of money by 1984, suggesting the need for an increase in the payroll tax rate or an increase in the taxable wage base.

Outlook: The December continuing resolution reduced the Employment Service staffing to approximately 17,000 positions. Since then, the House Appropriations Committee has agreed to supplemental appropriations for FY 1982 increasing the funds for Employment Service by $210.7 million. This brings the total staffing level to 24,800 staff years. Unemployment

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insurance workload increases, due to the higher unemployment rates, brought about an increase in Contingency Funds of $133 million in the same supplemental appropriation. As a result of this FY 1982 action, the Administration will propose an increase in ES funding for FY 1983 by $283.3 million above the amounts presented in the formal budget documents.

Federal Unemployment Benefits and Allowances

Funds in this category provide benefit payments and allowances to persons covered by the Trade Adjustment Assistance program and the Redwood Employee Protection program, as well as to ex-service members. The FY 1982 outlays of $306 million would be reduced to $35 million in FY 1983 under proposed legislation to eliminate cash assistance payments to TAA recipients as of July 1, 1982, except for recipients already enrolled in an approved training program.

Benefits available to unemployed federal workers would also be reduced by proposed legislation. Although the nature of the changes are not yet available, the provisions "will eliminate current disincentives to return to gainful work, and also reduce the potential for abuse of the federal disability compensation system," according to the FY 1983 budget. Outlays in this program (Federal Employees Compensation Act) will be $272 million in FY 1982 and $339.6 million in FY 1983. With a FY 1983 authorization of $397.6 million under current law, a savings of $58 million is assumed in this program.

Energy and the Environment

ENERGY

Following the oil embargo in 1973, Congress enacted a broad range of programs to reduce the nation's dependence on imported oil. Included was a variety of grant programs to fund energy conservation and emergency planning activities at the state level. The State Energy Conservation Program (SECP) has established states as the primary delivery mechanism for energy conservation programs, providing funds for state program and planning activities. The Energy Extension Service (EES) provides energy end-users with information and technical assistance on energy conservation and the use of renewable resources. The Institutional Building Grants Program, also known as the Schools and Hospitals Program, provides matching grants to schools and hospitals undertaking energy-conserving renovations. The Low-Income Weatherization Program is designed to help low-income families cope with rising energy costs by making their homes more energy efficient.

Last year, the Administration proposed the termination of funding for all these state conservation programs except the Schools and Hospitals Program. Although Congress refused to eliminate the programs completely, funding for each was reduced dramatically. The Administration has again proposed the termination of all the programs in FY1983, arguing that rising energy prices, public awareness of energy conservation benefits, and the high level of private investment in energy conservation mean that continued federal support for these programs is no longer warranted.

In addition, one of the President's tax proposals will be of concern to states using industrial development bonds to encourage alternative energy source development. Under the proposal, the use of IDBs for biomass, solid waste, small-scale hydroelectric, or other energy projects would be prohibited. Finally, the Administration has proposed the elimination of business energy tax credits, beginning in 1985.

FY 1983 Budget Proposal:

Budget Authority (in millions)

	FY 1981	FY 1982	FY 1983
State Energy Conservation	$ 48	$ 24	$ 0
Schools and Hospitals	150	48	0
Energy Extension Service	20	9.6	0
Low-Income Weatherization	175	144	0
Phaseout (Program Administration)			4
Total			4

Impact on the States: If the Congress agrees to terminate funding for state energy conservation activities, most state energy planning and program activities will either have to come to a halt or will have to be financed by the states. Many state energy offices may close.

Outlook: It is unlikely that Congress will support the complete termination of conservation funding to states, particularly the low-income weatherization programs. On the other hand, Congressional reluctance to support a state and local energy block grant, combined with a soaring deficit and the expected pressure to maintain adequate funding for some social service programs, may well mean further reductions in this area. Since these programs have already been reduced to a "bare bones" level, further cuts may endanger the viability of the programs.

Energy Reorganization

The Department of Energy was created in 1977 by the Carter Administration in response to growing concerns about energy shortages and the nation's increasing dependence on imported oil. The department grew to include 20,000 employees with a budget of over $10 billion. Its responsibilities have included energy research and development, demonstration programs, training, information collection, energy industry regulation, emergency planning and nuclear weapons development.

FY 1983 Budget Proposal: Consistent with its view that the federal government should play a more limited role in energy activities, the Administration has proposed disbanding the Department of Energy and redistributing its functions to other agencies. Under the reorganization proposal set forth in the budget, the Commerce Department would absorb most of DOE's current functions. A new agency, the Energy Research and Technology Administration (ERTA), would be created within the Department of Commerce to manage energy research and development (fusion, fission, environment, supporting research, fossil fuels research, and conservation and solar), uranium enrichment activities, general science, defense activities (nuclear weapons), and program administration. Also within Commerce, but not part of the new ERTA, would be non-R&D functions such as emergency planning, information collection and conservation grants management.

The Department of Interior will also receive several energy programs, including responsibility for the Strategic Petroleum Reserve, the Naval Petroleum Reserves, and the regional power marketing administrations. The Department of Justice would receive the remaining compliance and enforcement programs relating to energy industry regulation. The Federal Energy Regulatory Commission would become an independent agency, but would retain its current responsibility for wholesale gas and electric rate regulation.

Impact on the States: As with most of the Department of Energy's budget, those portions relating to state programs are jeopardized more by the proposed funding levels (zero) than by the proposed new structure for their administration. To the extent that the reorganization proposal deemphasizes energy as a national priority, however, states can expect less assistance and less guidance in the design and implementation of their energy programs.

Outlook: At this time there appears to be little congressional support for dismantling the Department of Energy. Opposition is generally based on two principal concerns: that energy should remain a national priority and should continue to be addressed by a cabinet-level agency; and that the proposed reorganization will not result in significant cost savings. Congressional opposition to the budget priorities reflected in the proposed reorganization is also growing, and there is strong sentiment on the Hill that the FY 1983 budget does not provide for a balanced national energy policy. For example, the proposed budget for (non-defense) nuclear programs is still over $1 billion, but funding for solar, conservation and fossil fuels research has been cut dramatically.

	Budget Authority (in millions)	
	FY 1982	FY 1983
Nuclear Fission	$ 1,089	$1,016
Nuclear Magnetic Fusion	454	444
Conservation, Solar, Renewables	518	101

ENVIRONMENTAL PROTECTION PROGRAMS

The President's FY 1983 request for the U.S. Environmental Protection Agency (EPA) is $3.6 billion which represents a 2.3% decrease from FY 1982 and a 32% decrease from FY 1981 levels. Research and development activities will decrease by 30% from FY 1982 and by 45% from FY 1981. A significant decrease in FY 1983 is proposed for federal abatement, control and compliance activities which would result in a total cut from FY 1982 of 17% and from FY 1981 of 33%. Grants to states and local governments for air, water and land pollution control programs would total $182 million, down 23% from FY 1982 and 33% from FY 1981. The Administration has requested a supplemental appropriation of $2.4 billion for FY 1982 to cover promised funding of the wastewater treatment construction grants program. An FY 1983 request of $230 million for "Superfund" represents a $40 million increase over FY 1982 levels.

Under the President's proposal, state and local governments would no longer receive funding for the following programs: Clean Lakes, Areawide Water Quality Management Planning (Sec. 208), Solid Waste Management, Resource Recovery, Noise Control and Toxics Enforcement. EPA will instead encourage states to assume more responsibility for environmental programs and expedite regulatory reform efforts to reduce the burden on the regulated community, state and local governments.

FY 1983 Budget Proposal:

EPA Budget (in millions)	FY 1981	FY 1982	FY 1983
State Grants for Pollution Abatement:			
Air Pollution	87.7	87.7	70.0
Hazardous Waste	26.5	41.0	35.1
Safe Drinking Water:			
Public Systems Supervision	29.5	29.5	23.6
Undergrown Injection Control	6.6	6.6	5.5
Water Quality Management (Sec 106)	51.2	51.2	40.8
Pesticide Enforcement Grants	8.0	8.7	6.9
Superfund	40.3	190.0	230.0
Wastewater Treatment Construction Grants	3,900.2	2,400.0*	2,400.0

* Supplemental appropriation pending in Congress

Impact on the States: The Administration's proposal to significantly reduce state grants for pollution control may hamper some states' efforts to meet compliance deadlines established by federal law. It should be noted, however, that mandates and compliance deadlines under the Clean Water Act and Clean Air Act are subject to congressional reauthorization this year. With fewer federal resources devoted to research and development and enforcement, states may anticipate receiving less technical assistance from EPA. On the other hand, EPA will work to streamline existing state program requirements aimed at reducing state administrative costs. While a significant increase in "Superfund" expenditures is forecost, the clean-up of abandoned hazardous waste sites may be hindered by EPA projections that only 19 remedial site clean-ups will be completed by the end of FY 1983.

NATURAL RESOURCES PROGRAMS

The Administration has identified the small state discretionary grant programs used for resource management as low priority and, therefore, does not request FY 1983 funding. The programs eliminated which were provided funds in the past include:

- water resources planning and management (Water Resources Council);
- coastal zone management state grants;
- urban park improvement and acquisition;
- historic preservation; and
- state park land acquisition (Land and Water Conservation Fund).

The Administration feels that these programs should be at the prerogative of state and local governments where priorities can be determined by the willingness of taxpayers and the private sector to finance such activities. Planning and construction financed at the local level will also result in more cost-effective solutions to land and water resource problems. Budget authority in FY 1981 for these eliminated programs was $248 million.

FY 1983 Budget Proposal: The Administration's budget would increase direct federal expenditures for western water projects funded by the Department of the Interior. The Administration will recommend funding new project construction after adoption of new financing and cost-sharing guidelines to shift the costs of such projects from the federal government to the direct beneficiaries. State grants for surface mining reclamation and enforcement activities are increased by $9 million in outlays from FY 1982 levels.

The budget continues to emphasize user charges and fee systems as a potential federal revenue source, e.g., increased user fees for national parks, recreation areas, historic sites, wild and scenic rivers, fish hatcheries and wildlife refuges. The FY 1983 budget reiterates the 1982 theme that user charges be employed to support deep draft harbors and channels as well as inland waterways.

Impact on the States: Many states were dependent upon the funds to assist them in resource management activities. Without this federal assistance, some states will have to abandon these activities or seek alternative funding sources.

General Government/Fiscal Affairs

General Revenue Sharing

General Revenue Sharing currently provides funding to approximately 39,000 jurisdictions. Federal controls are minimal, and are primarily designed to ensure public participation in spending decisions.

FY 1983 Budget Proposal: The Administration proposes to continue the $4.6 billion General Revenue Sharing program for local governments at the FY 1982 level through FY 1983 when the program expires. Along with reauthorization, the President has proposed that the program would then be turned back to the states as part of the federalism initiative, with a 100% pass through to the same local governments.

Payments in-Lieu-of Taxes

Payments in-lieu-of taxes provide fees to state and local governments for Federal lands located in their jurisdictions.

FY 1983 Budget Proposal: The Administration requested $45 million in budget authority for the payments in-lieu-of taxes program, down from the $95.5 million Congress appropriated in FY 1982 despite a similar budget request last year. Beyond the funding cut, the Administration is proposing legislation to change the formula under which county allocations are made by increasing the deductions taken against the county payments for other royalties or receipts shared with the state.

Social Security

The President has appointed a bi-partisan commission to study possible improvements in the Social Security program. The task force is chaired by Alan Greenspan, member of the President's Economic Policy Advisory Board, and its members were appointed by the President, the Speaker of the House and the Senate Majority Leader.

FY 1983 Budget Proposal: The FY 1983 budget proposal does not include any changes in the current social security program. Despite the extensive cuts in the other entitlement programs, social security benefits are continued on a current services basis. Full cost of living increases estimated at 8.1% for June 1982 and 6.5% for June 1983 are included.

In FY 1983 the Old Age and Survivors Trust Fund (OASI) is expected to increase by $16.4 billion due to an expanding beneficiary population and higher benefit levels due to cost of living increases. In FY 1983, the taxable wage base will rise to $35,100 from a base of $32,400 in FY 1982. The tax rate is 6.70% each for employee and employer effective January 1, 1982.

Outlook: In the short term, the large increases in payout in the OASI trust fund will not present an immediate problem because of the passage of legislation to allow interfund borrowing until December 31, 1982. Long term solvency problems in financing the social security system will be addressed after the recommendations of the social security reform commission are received by the President. This bipartisan commission is due to report to the President by December 1982.

Federal Employment

In 1981 the Executive Branch (excluding the Postal Service) employed the full-time equivalent of 2,110,700 civilian employees in 13 cabinet departments and 94 agencies. Of these, 947,000 were in the Defense Department.

FY 1983 Budget Proposal: The Administration's goal is to reduce the federal government workforce by 75,000 full-time equivalent employees during the 1982-1984 period. Agencies are encouraged to make the reductions in programs in which excessive growth has occurred.

Emergency Management

FY 1983 Budget Proposal: The Federal Emergency Management Agency (FEMA) budget demonstrates the Administration commitment to state and local assistance in civil defense as well as the continued viability of other disaster assistance programs. For civil defense, the Administration is requesting $219.7 million in budget authority for FY 1983, which represents an increase of $97.9 million over the FY 1982 level of $121.8 million. This program is in support of the President's decision to enhance the civil defense program in 1983, and provides the foundation for a federal, state, and local partnership that is essential in achieving comprehensive emergency management objectives.

The basic state and local assistance in the civil defense program is funded at $66.3 million in FY 1983, up from $50.0 million in FY 1982. In addition, $29.0 million is provided for radiological defense which is up from the $10 million level in FY 1982. This program provides to individual citizens and officials the skills and knowledge, situation information, and guidance needed to minimize the effects of fallout radiation hazards of a nuclear attack. It also provides support as appropriate for emergency response to peacetime nuclear incidents and other technical defense capabilities at all levels of governments.

Other specific increases in the civil defense section of the FEMA budget include:

- $46.2 million for nuclear attack civil preparedness, up from $11.6 million in FY 1982;
- $4.2 million for comprehensive emergency preparedness planning;
- $4.1 million for radiological emergency preparedness, up from $3.1 million in FY 1982. This provides for emergency preparedness and planning activities, nuclear facilities and radioactive materials and transportation involving radioactive materials;
- $53.6 million for flood plain management, up from $38.0 million in FY 1982; and
- $1.5 million for the Emergency Information and Coordination Center (EICC). The mission of the EICC is to provide FEMA with information, data and facilities for making accurate and timely decisions, including the communications required for rapid and reliable transmission of these decisions under all conditions.

Emergency Planning and Assistance

FY 1983 Budget Proposal: The Administration is requesting $188.0 million in budget authority to carry out activities under the Flood Disaster Protection Act of 1973, the Disaster Relief Act of 1974, the Earthquake Hazards Reduction Act of 1977, among others. The request represents an increase of $120.1 million over FY 1982 and includes:

	FY 1982 ($ thousands)	FY 1983 ($ thousands)
Civil Defense:		
Research	$ 8,717	$ 22,040
Training and Education	10,163	16,510
Telecommunications	10,305	25,252
Federal Preparedness:		
Government Preparedness	23,918	110,828
Resources Preparedness	1,191	2,852
Mobilization Preparedness	600	1,075
Strategic Planning	847	1,559
Training and Education	6,145	7,001

Human Resources

INCOME SECURITY

The scope of almost every income maintenance, social service and nutrition program will be further reduced in FY 1983. Federal payments under the three major needs-tested income assistance programs -- Aid to Families with Dependent Children (AFDC), Supplemental Security Income (SSI) and Food Stamps (FS) -- will be some $4.2 billion less than projected FY 1983 current services costs. Actual FY 1983 federal outlays will be about $3.2 billion below FY 1982 current service levels, a reduction of over 12% before the impact of inflation. New and continued block grants in energy assistance, community services, social services, child welfare services, rehabilitative services and welfare administration will total $6.6 billion, some $1.6 billion less than FY 1982. Funds for the Work Incentive Program (WIN), now at $245 million, have been eliminated and state funding for refugee and entrant assistance, now at $703 million has been reduced by $177 million. Aging programs are scheduled for a $78 million cut from the current dollar while Head Start funding is maintained at the FY 1982 level of $912 million. Although many of these reductions are passed directly through to individuals, others will have to be absorbed by the states or reflected in further program reductions substantially above the level projected in the budget.

Aid to Families with Dependent Children

The AFDC program is designed to provide assistance to single-parent families. The federal government sets general eligibility criteria and reimburses states for varying proportions of program costs. This program was substantially revised as a result of the Omnibus Reconciliation Act of 1981, with a projected $1 billion reduction in federal costs. It appears, however, that many of these savings will be postponed to FY 1983 due to the time required for full implementation.

FY 1983 Budget Proposal: The FY 1983 budget is based upon an additional 15 changes to be made in the federal standards for the program. These revisions are projected to save $166 million more in FY 1982 and $1.155 billion in FY 1983, putting total federal AFDC expenditures in FY 1983 some $2.2 billion below the FY 1982 level. The major changes to be imposed would (federal savings in parenthesis):

- require community work experience programs (CWEP) in every state ($ 49 million);
- mandate CWEP participation by unemployed parents ($ 86 million);

- mandate job searches for AFDC applicants ($145 million);
- remove parents or caretakers from the grant when they voluntarily quit work or reduce earnings (no estimated savings);
- eliminate the WIN program ($245 million);
- end parent benefits when the youngest child reaches 16 ($ 47 million);
- prorate shelter costs for shared households ($174 million);
- reduce benefits to reflect energy assistance as income ($175 million);
- count income of unrelated adults living with AFDC families ($ 69 million);
- include all minor children (except SSI) in assistance unit ($ 63 million);
- eliminate military service as deprivation factor ($ 16 million);
- round benefits to next lowest dollar ($ 10 million);
- prorate first month's benefit to date of application ($ 14 million);
- eliminate emergency assistance ($ 60 million); and
- eliminate reimbursement on erroneous payments over 3% ($234 million).

Impact on the States: The federal government assumes that most of these changes will produce comparable savings at the state level through benefit changes or caseload reductions. But some of the changes, such as the exclusion of a parent when the youngest child reaches 16, assume the availability of employment opportunities, and others, such as prorating of rent or broader eligibility units, assume that persons will voluntarily contribute to the care of children for whom they have no legal responsibility. To the extend that jobs are not found or contributions are not made, the state may have to pick up these costs not eligible for federal reimbursement.

In addition, the proposed program changes may substantially increase administrative costs. This is particularly true for work programs where the states will be required to expand work relief and job search programs while the WIN program is eliminated and federal aid for administrative costs is capped through the combined welfare administration grant. Efforts to reduce errors to the new 3% target will also require additional unreimbursed state administrative costs. Moreover, it is unlikely that the proposed 3% error rate targets can, in fact, be reached during the next fiscal year. The large number of program changes made over the past year may actually increase error rates while reducing total expenditures. If these targets are not met, the states will have to find monies to replace federal reimbursement (over $900 million in FY 1983 for all three programs) or make large reductions in benefits to eligible recipients.

The requirement that energy assistance benefits be counted in calculating AFDC essentially denies such recipients any benefit from the program. States may be subject to substantial pressure to increase basic benefits to make up for this loss and for reduced food stamp bonuses that result from the higher benefit reduction rate applied to welfare benefits.

Outlook: Congress, which made substantial reductions in the AFDC program last year and has passed a 4% error target in the past, is likely to approve these FY 1983 changes unless more information is made available on the actual impact of the proposed revisions on both recipients and states. The proposed AFDC amendments, along with similar food stamp changes, are an important element of the Administration's new federalism proposal. It is the combination of these changes which will reduce the level and growth rate of these two programs to the degree that the proposed Medicaid swap becomes advantageous to the states. Without these program reductions, Food Stamp and AFDC expenditures would exceed Medicaid costs in FY 1984.

Food Stamps
The Food Stamp program increases the purchasing power of eligible low income households by enabling them to purchase food with Food Stamp coupons at major retail stores. When the Food Stamp Act was reauthorized last year, major revisions in eligibility requirements and benefits were adopted, saving over $1 billion.

FY 1983 Budget Proposal: The Administration estimates total FY 1983 outlays for Food Stamps to be $10.4 billion (including $779 million for the Food and Nutrition Block Grant to Puerto Rico, authorized in the Omnibus Budget Reconciliation Act of 1981, and $41.5 million for a proposed Food and Nutrition Block Grant to the U.S. Territories). The estimated FY 1982 outlay for the same program is $11.3 billion. FY 1983 savings will be achieved by the implementation of a number of proposed legislative changes which would:

- count state and local energy assistance payments as income in determining eligibility and benefit levels;
- eliminate the earnings disregard;
- increase the benefit reduction rate from 30% to 35%;
- mandate workfare;
- cap federal administrative matching funds by including it in a welfare administration block grant; and
- institute a new quality control program that will limit federal payments for state error rates to 3% in FY 1983.

Impact on the States: The new quality control program would have a significant impact on states, penalizing them by over $600 million if the current 10.4% average error rate is not reduced to the 3% limit. The states would have to reimburse the costs on a dollar-for-dollar basis and would be unable to make benefit changes to recoup their losses. The disregard and benefit reduction revisions will reduce the value of food stamps to most low income persons, particularly those who work, and may lead to pressures for increased state funded welfare benefits.

Outlook: These proposals, like the AFDC changes, are closely related to the Administration's federalism proposal. The fiscal balance envisioned by the Administration requires these further large reductions in food stamp expenditures. Several of the legislative proposals have been proposed before and were rejected by Congress for their disproportionate impact on the poor. However, as in the case of AFDC and Medicaid, the error rate sanctions may be attractive to a Congress faced with large deficits.

Refugee and Entrant Assistance

This assistance program provides special federal funds to offset the additional welfare, medical and social services costs of refugees and entrants. Under current law, special needs tested benefits are available, at the state AFDC benefit level, to meet the needs of all refugees and entrants for a period of 36 months. Additional funds are made available for social services, education and resettlement activities. Funding for the refugee and entrants program is now separately administered.

FY 1983 Budget Proposal: The special funding for AFDC recipients would be continued for 36 months. Special funding for persons not meeting these categorical requirements would be discontinued after 18 months, except in states that have a general assistance program. Funding for the entrants and refugees would be consolidated in a single appropriation and the reception and processing of entrants would be transferred to the Justice Department and administered by the Immigration and Naturalization Service. Funds for the cash and medical assistance portion of the program are reduced by $88 million and funds for social services and education are cut by $89 million, from $535 million and $148 million, respectively.

Impact on the States: This proposal will shift a considerable financial burden to state and local governments. Local public health systems may be particularly hard hit. In addition, states expect to encounter some administrative difficulty in the conversion of cases after the first 18 months. While the number of refugees is projected to decline, this will have little immediate impact on state costs if the dependency rate remains high.

Outlook: There is considerable concern that the reauthorization of the Refugee Act may be jeopardized by the high cost of refugee assistance. Congress may be willing to accept these cuts to assure reauthorization of the program.

Supplemental Security Income
This program provides federal cash assistance payments to aged, blind and disabled individuals.

FY 1983 Budget Proposals: The federal government proposes to tighten eligibility and limit benefits in the federal program by:

- prorating initial benefits to the date of application and to the date of eligibility for the aged;

- redefining eligibility criteria to exclude disabling conditions expected to last from 12 to 24 months;

- increasing the weight given to medical factors in disability determination;

- authorizing recoupment of overpayments from social security benefits; and

- eliminating the disregard of $20 of income for new SSI recipients.

Impact on the States: The segment of the population with short-term (12-24 month) disabilities may be shifted to state general assistance rolls. Reductions in funding for both rehabilitation services and employment services make it unlikely that states will be able to find work for these persons. In addition, the reduction in disregarded income and the higher benefit reduction rates in food stamps will serve to make less money available to SSI recipients and may create pressure for increased state supplementation.

Outlook: The Administration has already tightened the eligibility review process for disability. Congress is unlikely to substantially reduce benefits for this program.

Combined Welfare Administration Block Grant
Under current law, states are eligible to receive federal reimbursement for all necessary expenses involved in the administration of the AFDC, Medicaid and Food Stamp programs. In general, the reimbursement level is 50% of costs, although some special priority activities are reimbursed at a higher rate.

FY 1983 Budget Proposals: Administrative reimbursement under the three state-administered programs would be consolidated into a single grant and capped at 95% of the FY 1982 level. State matching would be eliminated as would some of the detailed cost allocation requirements found in current regulations. Some higher matches in fraud control would be retained, although the details are not specified.

Impact on the States: The budget estimates that the cap will save the federal government $307 million in FY 1983. These costs must be assumed by the states unless they are able to reduce overall administrative costs accordingly. Such reductions are extremely unlikely in the face of new administrative requirements contained in the budget. The loss of WIN funding and new work requirements could substantially increase costs, as could expanded error reduction efforts needed to avoid sanctions.

The present cap will continue the unequal investment in administration across the states and delay the further computerization of the welfare and Medicaid systems.

Outlook: Elements of this proposal seem inconsistent with the Administration's new federalism plan. The inclusion of Medicaid administration costs will make the redistribution of resources more difficult when that program is federalized. Moreover, a cap would appear to discourage administrative improvements in Medicaid during the transition year.

Social Security

The FY 1983 Budget contains no recommended changes in the Social Security Program other than those enacted into law in 1981. Social Security is being studied by a bipartisan commission, and no action is recommended by the Administration pending the report of that commission. The tax rate for Social Security will remain at 6.7% for 1983, although the wage base subject to tax is scheduled to increase an additional $2,400 to $35,100 per year. Program costs are expected to increase by almost $17 billion, while beneficiaries increase by about 300,000.

HEALTH CARE FINANCING

In the state administered Medicaid program, federal outlay savings of $2 billion are proposed from the FY 1983 current services estimate of $19 billion. About half of these savings would result from the shifting of federal costs to the states; federal cost reductions of $867 million are proposed through federal matching rate reductions. These federal match reductions would be in addition to the 3% FY 1982, 4% FY 1983, and 4.5% FY 1984 cuts adopted last year. A $612 million savings would be achieved through federally mandated cost-sharing by Medicaid recipients and increased state latitude to recover long-term care costs from beneficiary estates and relatives. Other savings include changes in AFDC and SSI policy and the reduction in the state eligibility error rate tolerance levels. For the federal Medicare program, budget savings of $2.5 billion are proposed from the FY 1983 current services estimate of $57.8 billion.

Medicaid

FY 1983 Budget Proposal: Medicaid outlays of $17.0 billion are proposed for FY 1983, $2.0 billion under the FY 1983 current services estimate of $19.0 billion. Also, $200 million in reductions from FY 1982 current services outlays are proposed. (The FY 1982 current services outlay figure of $18.1 billion includes about $890 million in federal funds for state and local administration, while the FY 1983 outlay request of $17.0 includes only about $27 million for these functions because of their transfer to the welfare administration block grant. The recommended reduction in budget authority is much larger than the outlay reduction because of a $4 billion technical accounting change that would no longer recognize appropriations from the subsequent year as available.)

Almost half of the proposed FY 1983 Medicaid savings are from reductions in federal Medicaid matching rates. A $600 million reduction would be obtained by reducing each state's matching rate by three percentage points for optional health services (e.g. drugs) provided to categorically eligible recipients and for all services for the medically needy. A savings of $203 million would be achieved through elimination of federal matching funds for state payment of the Medicare Part B premium. In addition, a federal expenditure reduction of $64 million results from a proposed cut in the matching rate for family planning services from the current 90% down to each state's normal Medicaid matching rate, (i.e., from 50 to 78%, depending on the state) and from a reduction in the matching rate for state certification activities from 75% to 50%.

A federal requirement for cost-sharing by Medicaid recipients is estimated to result in FY 1983 federal savings of $329 million. Proposed federal legislation would establish a $1 and $1.50 per visit co-payment for the categorically and medically needy, respectively, for physician, clinic and hospital outpatient department services. In addition, a $1 (categorically needy) and $2 (medically needy) co-payment per day would be required for inpatient hospital services.

Legislation to enhance state ability to recover costs from deceased recipients' estates, and to allow states to require that adult children of institutionalized Medicaid recipients contribute to the cost of their parents' care, would achieve an estimated federal savings of $183 million. An additional $100 million savings would be realized through regulatory changes to allow states to recover long-term care costs from relatives.

A $59 million federal savings is budgeted for the phasing in of a 0% eligibility error rate. As in AFDC, the current 4% eligibility error rate target is to be reduced to 3% in 1983, 2% in 1984, 1% in 1985, and 0% in 1986. In addition, a combined welfare administration block grant, proposed at 95% of FY 1982 funding, is to replace open-ended matching funds for administrative costs in the Medicaid, AFDC and Food Stamps programs. (See welfare administration block grant in the Income Security section.)

Caseload reductions from proposed changes in the AFDC and SSI programs are budgeted to achieve Medicaid savings of $153 million and $176 million, respectively (See Income Security section). In addition, a $75 million savings is included in the proposal to reduce to one month the eligibility extension for recipients who lose AFDC eligibility because of earned income. A Medicaid cost reduction of $25 million is associated with proposed initiatives in the Medicare program.

Impact on the States: The proposed changes in Medicaid would shift substantial federal costs to the states. The impact on a given state of the three percentage point reduction in federal matching funds for optional services and services for the medically needy will depend on the scope and composition of the state Medicaid program structure. It should be noted, however, that intermediate care facility services, which account for about 27% of Medicaid vendor payments nationally, are technically an "optional" service. In a number of states with very tight eligibility and service coverage policies, intermediate care facility services account for an even larger proportion of program expenditures than the national average. To provide an example of the impact, let us assume a state in which optional services and/or the medically needy account for 60% of program expenditures, and the state would otherwise receive a federal matching rate of 70%. A 3% matching rate decrease in 60% of program expenditures would mean a decrease of 1.8% of total program costs. This would mean that the federal share has been reduced to 68.2%, while the state share has been increased from 30% to 31.8%. In other words, state costs have been increased by 6%. (i.e. 31.8÷30=1.06)

The proposal to eliminate federal matching funds for state payment of the Medicare Part B premium would increase state costs by the $203 million federal "savings." All but four states and two territories now receive such matching funds, and one of the four states has an agreement to initiate the program on October 1, 1982. It should be noted that these federal matching funds are now available for the categorically needy, but not for the medically needy. The elimination of special matching rates for family planning services and state certification activities would shift an estimated $64 million in federal expenditures to the states.

The mandatory co-payment proposal is intended to reduce the unnecessary use of medical services and should result in both federal and state savings. States have pressed for state latitude to implement nominal co-payments for mandatory services, with the ability to apply selective co-payments only to certain services, diagnostic groups and settings. For example, to encourage use of cost-effective settings, some states may like to require a co-payment solely for services rendered in unnecessarily expensive settings, such as inpatient departments. Other states would not impose co-payments on elderly recipients who are medically needy or who reside in nursing homes because of their need for care and the administrative problems associated with the relationship among co-payments, patient pay and spend-down requirements. Other states indicate that they would not implement such co-payments at all. While the Administration's proposal would implement co-payments for mandatory services, it would not give states the policy latitude desired.

States would share in the savings from the proposal to give them flexibility to recover long-term costs from recipient estates and to require adult children to contribute to the cost of their parent's care in nursing homes. States have asked the Administration and Congress for the ability to recover these costs. The savings obtained in each state will depend entirely upon state policies and programs.

The reduction from four months to one month in extended eligibility for clients dropped from AFDC may mean a decrease or an increase in state and federal costs, depending on client behavior. The four-month Medicaid eligibility extension is intended to improve incentives for AFDC recipients to work. If fewer AFDC recipients obtain jobs because of the more immediate loss of Medicaid benefits, this proposal will increase federal and state costs. If the difference between a one-month and four-month extension of Medicaid coverage is inconsequential to recipients in their consideration of potential work, or if AFDC recipients do not understand current policies anyway, the proposal will reduce state and federal costs.

<u>Outlook</u>: It is difficult to predict congressional action on the proposed Medicaid budget cuts because such action will almost certainly be driven by decisions regarding overall federal spending. It seems likely that if the states strongly oppose the federal funding reductions, Congress will not shift additional federal Medicaid costs to them. It also seems likely that the states can obtain increased flexibility to reduce federal and state costs through recipient co-payments and the contributions of recipients' relatives to the cost of care.

Medicare

FY 1983 Budget Proposal: The budget proposes to reduce Medicare expenditures by some $2.5 billion from the FY 1983 current services budget of $57.8 billion and to increase Medicare hospital insurance trust fund revenues by $619 million. About $1.9 billion in savings is associated with adjustments to provider reimbursement policies, with $653 million of these savings coming from an interim 2% pro rata reduction in hospital reimbursement. Another $306 million in savings would result from making Medicare coverage secondary to private group insurance for the working aged. The revenue increase would result from bringing federal workers, who do not now pay Social Security taxes, under Medicare Part A. This would make federal workers eligible for Medicare by virtue of federal employment for the first time.

Impact on the States: Some of the controls and refinements proposed for provider reimbursement policies should reduce somewhat the health care cost escalation faced by the states. The 2% reduction in Medicare hospital reimbursement would be imposed on all hospitals, regardless of how efficient they are or how effectively they have controlled cost escalation. The proposal does not provide incentives to control costs. Thus, the implications for state Medicaid costs are not clear. If a state Medicaid program uses Medicare hospital reimbursement principles, it might be able to impose the same pro rata reduction. More generally, however, the pro rata reduction in federal reimbursement would probably be offset by increased costs to other payors, including state and local government. It probably would not reduce overall hospital cost increases faced by the states, unlike alternative proposals to develop prospective hospital reimbursement policies in Medicare that reward efficiency and do not subsidize waste.

Outlook: Congress will likely adopt alterations in Medicare provider reimbursement policy to reduce federal costs, but will probably modify the proposed pro rata reduction in hospital reimbursement.

HUMAN RESOURCES PROGRAMS

The policies the Administration inaugurated last year--major consolidations of categorical programs coupled with large funding cuts--are repeated in the FY 1983 budget. For many of the nutrition, health and social service categorical programs not slated for consolidation, the effort to phase out programs or sharply reduce federal aid continues.

Since all of the human resource block grants will be subsumed as part of the federalism initiative, the congressional response to the major funding reductions proposed will be crucial in setting the actual cost of the dozens of programs to be returned to the states in FY 1984 and the corresponding amount of revenue turned back. The following are major proposals for consideration:

- The President has proposed the creation of a new Child Welfare block grant; the merger of the Maternal and Child Health block grant with both the WIC (Women, Infants and Children) nutrition program and the commodity supplemental food program to form a new Services for Women, Infants and Children block grant; expansion of the Primary Care block grant to include the family planning, migrant health and black lung programs; and consolidation of the Low-Income Energy Assistance block grant with the AFDC emergency assistance program. No structural changes have been proposed for the Community Services, Social Services, Achohol/Drug Abuse/Mental Health, or Preventive Health/Health Services block grants. Compared to the FY 1981 funding level of $8.5 billion for the categorical programs folded into the eight block grants, and the FY 1982 funding level of $7.2 billion for the mix of categorical and block grant programs reshaped into the eight block grants, the FY 1983 $5.7 billion funding request for all of the health and social service block grants represents a cut of 33% and 21% respectively. From FY 1982 to FY 1983, one block grant--Community Services--would be slashed 71%. Four more--Child Welfare; Services for Women, Infants and Children; Low-Income Home Energy Assistance; and Social Services--would be reduced in the range of 18%-28%. The remaining three would receive level funding.

- Several categorical nutrition programs--summer feeding, special milk, school breakfast and child care programs--would be eliminated or reduced.

- The effort to phase-out the federal health planning program will continue.

- Aid to states for social and nutrition programs under the Older Americans Act would be reduced 11%.

- Two of the preventive health programs which suffered major budget cuts last year--VD and child immunization--would receive modest increases in FY 1983.

Health and Social Service Block Grants

The Omnibus Budget Reconciliation Act consolidated over 20 health and social service programs into seven block grants. The decision was a major victory for the Administration, although the consolidation of a much larger number of categorical programs into only four block grants had been requested. Congress agreed to give states--the recipients of the health and social service block grants--most of the decision-making power previously exercised by the Department of Health and Human Services (HHS). Congress also reduced dramatically the paperwork and procedural requirements. However, Congress did not give states as much flexibility or simplification as the Administration had sought.

At the same time, Congress substantially cut federal funding for the seven block grants from $6.744 billion in FY 1981 to $5.610 billion in FY 1982, a 17% reduction. One block grant --Low-Income Home Energy assistance--was cut only 5%, while the remaining six block grants were cut from 18%-26%. A 25% cut for each block grant had initially been sought by the Administration; in September 1981, the Administration revised its budget and requested an even greater 31% cut.

FY 1983 Budget Proposal: The pattern set for FY 1982--major program consolidations and large funding cuts--is repeated in the FY 1983 budget.

Child Welfare Block Grant

An entirely new Child Welfare block grant, to be composed of the former child welfare services, child welfare training, foster care and adoption assistance programs, has been proposed. The block grant would provide "greater flexibility to develop service delivery mechanisms tailored to specific local needs" and eliminate overlapping planning and reporting requirements. No real details on the new block grant have yet been released. Presumbably, the model offered by the Administration last year--which Congress generally accepted--will be used again.

Last year, funding for the four categorical programs to be folded into the new block grant was reduced from FY 1981 levels of $522.9 million to FY 1982 levels of $465.1 million, an 11% cut. The Administration now proposes another reduction for FY 1983, down to $380.1 million, an additional cut of 18%. From FY 1981 to FY 1983, the reduction would be 27%.

Services for Women, Infants and Children Block Grant

The Administration has asked that the Maternal and Child Health block grant created last year be merged with the much larger WIC (Women, Infants and Children) nutrition program as well as with the commodity supplemental food program. HHS now runs the Maternal and Child Health Block Grant; the Department of Agriculture administers the two food programs; the combined program, would be handled by HHS. Arguing that "improvement in health status is much greater when supplemental nutrition is combined with improved access to health care," the Administration believes that states will be better able to provide a "full range of health services for women and children" under the new block grant. Presumably, states would be free to replace WIC eligibility and service criteria with their own under the block grant and would be able to provide women and children with new combinations of nutritional and medical care; on these points, however, the FY 1983 budget documents are not specific.

FY 1983 Budget Proposal: From FY 1981 to FY 1982, funding for the constituent parts of this new block grant was reduced from $1,385 million to $1,286 million, a 7% cut. A much larger reduction--down to $1,000.0 million, an additional 22%--is proposed for FY 1983. From FY 1981 to FY 1983, the reduction would be 28%.

Primary Care Block Grant

The legislation establishing the Primary Care block grant stipulated that the block grant not take effect until FY 1983 and that thereafter participation would be optional for each state.

The Administration now proposes to merge the yet inoperative Primary Care block grant with three categorical federal health programs: black lung services, migrant health services and family planning. Though the budget documents are not explicit, the Administration presumably intends to keep the October 1, 1982 start-up date but eliminate the state option of picking up the block grant or leaving the program in federal hands.

FY 1983 Budget Proposal: The programs making up the Primary Care block grant received $535.0 million in FY 1981 funding and were reduced to $414.8 billion in FY 1982, a 22% drop. However, approximately level funding is proposed for FY 1983.

Low-Income Home Energy Assistance Block Grant

Last year, Congress rejected an Administration proposal to combine the AFDC emergency assistance program with the old low-income energy program. Thus, only the latter was included in the Low-Income Home Energy Assistance block grant. This year, the Administration will try again. The proposed merger is designed to expand the scope of the block grant so that funds could be used as needed for both non-energy crises and energy assistance. Presumably, no requirement will be proposed fixing the percentage of funds that must go into non-energy and energy uses, although the FY 1983 budget documents are not explicit. The Administration has proposed to alter the distribution formula to target funds towards states most in need due to their heating costs in the winter. There will also be an effort to eliminate some of the existing reporting requirements, assurances and compliance procedures.

FY 1983 Budget Proposal: The two programs in question did not undergo major dollar cuts last year. Their combined funding was cut from $1,905.0 million in FY 1981 to $1,807.2 million in FY 1982, just over 5%. However, a major reduction to $1,300.0 million, a 28% cut, is proposed for FY 1983. The FY 1981 to FY 1983 change would thus be -32%.

Other Block Grants

The remaining four health and social service block grants--Community Services; Social Services; Alcohol, Drug Abuse and Mental Health; and Preventive Health and Health Services--would not be structurally changed. Two of them, however, would receive substantially less funding; the other two would be level-funded.

FY 1983 Budget Proposal: The Community Services block grant was reduced from $473 million in FY 1981 to $348 million in Fy 1982, a 26% cut: It would be slashed by over two-thirds, to $100 million, in FY 1983. Thus, over two years, community services funding would decline nearly 80%.

The Social Services block grant was cut from $2,991 million in FY 1981 to $2,400 million in FY 1982, a 20% drop. For FY 1983, a nearly equal reduction to $1,974, an 18% cut, is proposed. Over two years, Social Services block grant funding would thus decrease by 34%.

The Alcohol/Drug Abuse/Mental Health and Preventive Health/Health services block grants underwent major funding cuts between FY 1981 and 1982. The former fell from $549 to $432 million, a 21% decline. The latter went from $99 million to $81 million, an 18% decrease. Both block grants would be held at their FY 1982 levels for FY 1983.

Impact on the States: States would generally benefit from the consolidations and other structural changes proposed by the Administration. Their capacity to target funds on those they determine to be most in need, and their ability to increase the ratio of service-to-administration expenses, will be enhanced by the greater flexibility and the fewer requirements which the Administration seeks.

These gains must be weighed against the dramatic funding cuts proposed for five of the eight block grants. Total funding for the block grants--which was already reduced from $8.5 billion in FY 1981 to $7.2 billion in FY 1982, a 15% cut--would be cut at an even larger amount, to $5.6 billion, in FY 1983, a 21% decrease. Community services would be nearly wiped out by the 71% funding cut proposed. Far fewer low-income citizens can be helped to stay warm in the winter, far fewer pregnant women and newborn children can be given nutritional and medical care if the block grants serving them are cut by an additional 28% and 22%, respectively, as proposed. The level of services provided to children, handicapped persons and elderly individuals will undoubtedly be reduced if the Child Welfare and Social Service block grants are reduced by 18% each.

Last year, when states' economies and budgets were in better shape, and when significant administrative savings were expected to result from the consolidation of categorical programs into block grants, some state officials warned that they would be compelled to eliminate or reduce needed services or raise taxes if cuts in block grant funding exceeded 10-15%. This year, with most states in worse economic and budgetary shape, and with fewer administrative savings left to balance against block grant funding cuts, it seems even more likely that state services and assistance in a broad range of health and social programs will have to be cut back, or taxes increased, as a result of the 21% reduction for FY 1983 requested by the Administration.

Outlook: Congress is likely to give the Administration's block grant proposals a rough time for a number of reasons. In general, there is far greater willingness this year among members of Congress to raise questions about, and disagree openly with, the Administration.

Specifically: (1) the same members who last year resisted inclusion of the child welfare services, child welfare training, foster care and adoption assistance programs into the Social Services block grant will have problems with the consolidation of those programs in a Child Welfare block grant; (2) the merger of the Maternal and Child Health block grant with the food programs requires cooperation between the health and agricultural committees of Congress, which has always been difficult to achieve; (3) the argument raised last year that states could not effectively deal with migrant health and family planning will again be raised to prevent the inclusion of those federal programs in the Primary Care block grant; (4) there will be concern that the merger of the two emergency assistance programs--one for energy, one for general crises--will deprive those needing heat in the winter of adequate resources; and (5) there will be strong objections is some quarters to the near-elimination of community services.

Apart from the difficulties many in Congress will have with the policies of the Administration, there will be widespread resistance to the major funding cuts proposed.

Finally, there will be a certain disinclination to make the structural changes and funding cuts proposed in light of the far broader proposal to eliminate all of the block grants starting in FY 1984 as part of the Administration's federalism initiative.

These problems, which will loom larger as the 1982 election draws nearer, may make it difficult for the Administration to achieve its objectives.

Child Nutrition

FY 1983 Budget Proposal: The Administration proposes to maintain current services funding for the large school lunch program, $2.2 billion for FY 1983; however, assistance to school lunch programs operated in schools on military installations would end. The Administration intends to eliminate or reduce a number of smaller nutrition programs. The special milk, summer feeding and nutrition education programs, which totaled $92.5 million in FY 1982, would be terminated. Funding for the school breakfast and child care feeding programs, which totaled $612 million in FY 1982, would be replaced by a $488 million block grant to states, a 20% reduction. As described above, the Maternal and Child Health block grant ($348 million in FY 1982) would be expanded--and renamed--to incorporate the WIC (Women, Infants and Children) nutrition program and the commodity supplemental food program ($394 million in FY 1982). The combined program would receive $1 billion in FY 1983 funding, a 22% reduction.

Health Planning

The Health Planning program was established to promote equal access to quality care at a reasonable cost. The program operates through a network of local health planning agencies (HSAs) and state health planning and development agencies (SHPDAs). Federal support is primarily provided through formula grants to approximately 186 HSAs and 57 SHPDAs.

FY 1983 Budget Proposal: Consistent with the Administration's plan to reduce regulatory programs and to strengthen competition in the health care industry, the budget eliminates all budget authority for state and local health planning programs except for $2 million for phase-out activities initiated in the FY 1982 budget. Under the FY 1982 continuing resolution, budget authority for state health planning programs is estimated at $19.2 million while budget authority for local programs is estimated at $37.7 million.

Impact on the States: All states currently operate state health planning programs as required in the National Health Planning and Resources Development Act of 1974. This Act expires on September 30, 1982. If the Act is not reauthorized, or if the phase-out of funding continues, each state will have to decide whether it wants to continue a health planning program with state funds.

Outlook: It is too early to determine if any type of federal health planning program will be reauthorized. One option that may be under consideration is to authorize a modified planning program that allows states the option of continuing health planning activities with some type of federal financial assistance.

Aging Programs

FY 1983 Budget Proposal: The Older Americans Act authorizes states to provide social services and nutrition assistance to senior citizens. The Administration has requested $606 million for these programs in FY 1983, a 10.6% reduction from the FY 1982 levels. In addition, a $2 million reduction has been recommended for state administrative support. The Administration would repeal the $266 million Senior Community Employment Program (SCEP) authorized under Title V of the Older Americans Act and replace it with a nationally administered $200 million work and training program targeted to special populations, including older workers, migrant and seasonal farmworkers, displaced homemakers, Indians and dislocated workers. States received approximately $64 million under the SCEP program in FY 1982, the rest going to eight national contractors. It is not clear how the new program funds would be allocated. Older Americans volunteer programs, Foster Grandparents and the Retired Seniors Volunteer Program (RSVP) are to be funded at $87.9 million in FY 1983, a slight increase over the FY 1982 level.

Impact on the States: Compared to other human resource programs, the programs for older Americans fared well in the FY 1983 budget. However, states will be forced to reduce services or raise taxes to compensate for the program reductions that have been proposed and the decline in administrative funds. States which now receive funding under the SCEP program could lose substantial federal aid if, under the new program for older and other workers, the funds are channeled elsewhere.

Outlook: It is very difficult to cut programs assisting the elderly at any time, but particularly in an election year. It is likely that more money will in fact be appropriated for elderly nutrition programs for FY 1983. Repeal of the SCEP program is highly unlikely, as the program is popular and has strong bi-partisan support.

Preventive Health Programs

The preventive health programs operated by the Center for Disease Control are aimed at detecting, controlling and preventing infectious diseases and occupational and environmental hazards. The programs of interest to the states include VD, childhood immunization, chronic disease and environmental health programs.

FY 1983 Budget Proposal: After seeking and obtaining major budget reductions last year, the Administration is asking for modest funding increases as part of the FY 1983 budget. Funding for the VD program, which was reduced from $57 million in FY 1981 to $38 million in FY 1982, is slated for a partial restoration to a $45 million funding level in FY 1983. Grants to states will total $40 million. Childhood immunization programs, which were cut from $44 million in FY 1981 to $28 million in FY 1982, would be increased to $29 million for FY 1983.

The chronic diseases program, reduced from $22 million in FY 1981 to $17 million in FY 1982, would be boosted to $20 in FY 1983. These funds provide support to states for detecting, controlling and preventing chronic conditions. Support for 20 state diabetes control projects and technical assistance for state nutrition surveillance systems is included in this request. Local and state environmental health activities and epidemiological field work designed to assess and control health hazards would be reduced from $6 million in FY 1982 to $4 million in FY 1983.

International Trade and Foreign Relations

The changes in the President's FY 1983 budget proposal reflect the continuing conflict within the Administration over federal export policy to deal with international economic realities. These realities include a decline in U.S. competitiveness in trade, a decrease in world market share, a growing trade deficit, an increase in unemployment as a result of trade policy, and a host of trading partners oriented toward government activism in trade and large subsidies of their exports. While that segment of the Administration which hopes to realize a free-market economy and reduce government subsidies supports the proposed decreased outlays for the Export-Import Bank in 1983, the fact that the Commerce Department's international trade division has done relatively well in the budget gives strength to those Administration officials arguing that government promotion of exports means more jobs, faster economic growth, and accelerated capital development.

OFFICE OF THE U.S. TRADE REPRESENTATIVE (USTR)

The Administration proposes $9.5 million in outlays for the U.S. Trade Representative. This is an increase of 11.1% over estimated FY 1982 outlays of $8.6 million. The FY 1983 increase will be absorbed in maintaining current operating and personnel expenses. USTR has the responsibility for conducting U.S. affairs related to the General Agreement on Tariffs and Trade (GATT).

DEPARTMENT OF COMMERCE

The proposed budget of the International Trade Administration (ITA) for FY 1983 indicates that trade development remains an important priority. Outlays for FY 1983 are proposed at $141 million, compared to $144 million in FY 1982. Most major program areas will see an increase in the new fiscal year, except for International Economic Policy which will register the largest cut ($27.8 million) due to the proposed elimination of trade adjustment assistance to firms adversely affected by imports. The policy office of ITA, however, will not suffer severe reductions. ITA's Office of Trade Development will be allocated $100 million in FY 1983, an increase of $9.5 million over the current year. Most of the new money will support the Foreign Commercial Service. The Office of Trade Administration is getting a small increase ($578,000) to improve the export licensing process and to meet an expected increase in import cases. The importance to the states of ITA's FY 1983 budget lies in what did not happen. Commerce has managed to postpone, at least for one year, an OMB plan to turn export development over almost entirely to the states and the private sector. The plan which DOC successfully resisted called for more than $70 million in cuts. FY 1983 will give states breathing room for one year to plan how they can promote trade at home and abroad with almost no federal assistance.

EXPORT-IMPORT BANK

In the area of export finance, the FY 1983 budget reflects the view of those in the Administration who consider export promotion a subsidy to business. The figures below indicate that a 13% cut in direct credit and in loan guarantees and insurance is proposed for the next fiscal year.

Table : The Export-Import Bank Authorization
($ Millions)

	FY 1981	FY 1982	FY 1983
Direct Credit	$ 5,461	$ 4,400	$ 3,830
Guarantees/Insurance	8,059	9,220	8,000

The cuts will further undercut U.S. competitiveness. In 1974, Eximbank direct loan authorizations financed 5% of U.S. exports and in 1982 the bank financed 2%. This drop has occurred as the trading system has become increasingly competitive.

Lost sales of U.S. products will be seen in increases in unemployment, losses in state revenues, and higher transfer payments.

Law and Justice

The FY 1983 budget for law and justice programs reflects the Administration's belief that public safety is primarily a state and local responsibility. Thus, the budget proposes the elimination of funding for juvenile justice programs and the Legal Service Corporation, the continued phase-out of the Law Enforcement Assistance Administration, a reduction in the Treatment Alternatives to Street Crime program, and a termination of state and local drug grants. The Administration plans to put more emphasis on assistance to state and local public safety programs by direct cooperation between federal law enforcement agencies and their state and local counterparts. Federal prosecutors will establish advisory councils in their districts to determine the most pressing law enforcement problems, and how federal resources can be coordinated with state and local resources to handle them. In this way, duplication of effort will be reduced, and state and local law enforcement officials can receive maximum assistance from federal officials.

FY 1983 Budget Proposal: The Administration has proposed $2.7 billion for FY 1983 in budget authority for the Department of Justice. This represents an increase of 8% over the current $2.5 billion budget authority. The Office of Justice Assistance, Research and Statistics which provides staff support and coordinates the activities of the Office of Juvenile Justice and Delinquency Prevention, the National Institute of Justice and the Bureau of Justice Statistics, is provided FY 1983 budget authority of $55.7 million, a decrease of $77.9 million from the $128.6 million level of FY 1982. The Administration's budget proposes to continue the phase-out of the Law Enforcement Assistance Administration and to begin phase-out of the OJJDP. No budget authority is provided for juvenile justice grants, juvenile justice programs or crime control programs. The Administration plans continued funding in FY 1983 for the Public Safety Officers' Benefit Program at $10.8 million, a slight increase from the $10.1 million level in 1982. The National Institute of Justice and the Bureau of Justice Statistics would maintain current levels of service under the FY 1983 budget. Budget authority for these programs will be $37 million, up from $35 million in FY 1982. This reflects no program change.

The National Institute of Corrections has been slightly reduced in FY 1983 to $11 million budget authority from the FY 1982 budget level of $11.2 million. In addition, the Administration requested $30.7 million in budget authority for the Support of the United States Prisoners Program, an increase of $6.6 million from FY 1982. While this program primarily finances the detention of federal prisoners and detainees in local jails for short periods of time, cooperative agreements will be negotiated during FY 1983 for the renovation and equipping of local facilities that house federal prisoners.

Impact on the States: The Administration is committed to reducing the federal role in the Law and Justice area, particularly where states and localities previously received fiscal assistance from the federal government. Thus, states will have to use their own resources to fund any innovative program development in the criminal justice area (even if programs address perceived national problems) and allocate part of the social services block grant to provide legal services to the indigent. States, however, can expect some criminal justice technical and statistical assistance from BJS and NIJ for the coming fiscal year.

Outlook: Congress will probably restore funds for the Office of Juvenile Justice and Delinquency Prevention and the Legal Services Corporation. The Administration attempted to eliminate both programs in FY 1982, only to have them restored by Congress.

Transportation

The FY 1983 budget proposal reconfirms the decline in federal support for transportation and the shift from new construction to preserving the existing transportation infrastructure. The Administration proposes no new major program initiatives. Total outlays are expected to decline by $1.6 billion and most programs continue in a holding pattern pending congressional action on the President's proposal to turn major responsibilities back to states and localities. Major features of the budget include a federal aid highway obligation ceiling of $7.7 billion, a drop of $300 million from FY 1982; a 38% reduction in urban mass transit operating assistance; small cuts in urban mass transit capital programs; continuation of the airport development program at the same $450 million level; significant reductions in assistance to Amtrak and for state community safety grants; and elimination of rural public transportation aid and local freight rail assistance.

HIGHWAY AND HIGHWAY SAFETY

The federal aid highway program consists of a number of individual categorical highway programs operated by the states with federal assistance. After Congress passes authorizing legislation for the various categorical programs, the Federal Highway Administration notifies each state of the amount it can spend for each highway program, based on the formula that governs that program. Such an apportionment gives each state the authority to contract for highway projects before receiving federal funds for the projects. States then let contracts to construct federally-approved projects based on their apportionment and their ability to raise funds to meet federal match requirements. States pay the state and federal share of the projects as work progresses.

Each year Congress appropriates a sum of money from the Highway Trust Fund, called liquidating cash, to reimburse states for the federal share of highway projects. This system of contract authority allows states to begin long-term highway projects in advance of appropriations which pay the federal share, assuring the funding needed for large scale highway projects.

Contract authority for federal aid highways is found in authorizing legislation and does not require an appropriation. In recent years, however, transportation appropriations bills have included a ceiling on the amount of total new state obligations for federal highway programs.

The obligation ceiling has usually been lower than total authorizations available for all highway programs. The obligation ceiling in a transportation appropriations bill is the most significant determinant of highway program level for that year.

All major federal aid highway programs are financed through the Highway Trust Fund. The federal government collects a four cent per gallon excise tax on motor fuel plus other excise taxes on new truck and trailer sales, truck and bus parts and accessories, and tires. The motor fuel tax accounts for about two-thirds of these collections. All the highway user excise taxes are placed in the Highway Trust Fund, and liquidating cash is drawn from it to reimburse states for the federal share of highway projects. The balance in the trust fund reached a high of $12.5 billion at the end of FY 1979, and declined to $9.3 by the end of FY 1981, and will decline even further in FY 1982 due to shrinking revenues from the motor fuel excise tax.

The Surface Transportation Act (STAA) of 1978 and the Federal Aid Highway Act of 1981 contain the current authorizations for federal aid highway programs. Both laws expire at the end FY 1982. Congress must pass new authorization legislation before October 1982 for the programs to continue. The following table gives authorization levels for major programs for the current and the past two fiscal years.

HIGHWAY PROGRAM AUTHORIZATIONS
($ Millions)

Programs	FY 1980	FY 1981	FY 1982
Interstate Construction	$3,500	$ 3,200	$3,100
3R (4R for FY 1982)	275	275	800
Primary System	1,700	1,800	1,500
Secondary (Rural)	550	600	400
Urban	800	800	800
Bridge Replacement & Rehabilitation	1,100	1,300	900
State and Community Safety Grants	200	225	92.5
Safety Construction Programs	340	340	390

Interstate construction is clearly the most expensive federal highway program. Current estimates are that completing the remaining gaps in the system will cost about $40 billion. The major recent shift in the federal highway program is the increased emphasis on preserving completed sections of the interstate system. The 3R program, which is exclusively for interstate highways, was expanded to a 4R program in 1981 by adding reconstruction as a eligible activity to resurfacing, restoration, and rehabilitation. The obligational ceiling for highway programs increased from $7.8 billion in FY 1980 to $8.75 billion in FY 1981, before falling back to $8.0 for FY 1982.

The Reagan Administration in 1981 as part of a multi-year highway bill proposed eliminating the secondary and urban systems programs, in effect turning these back to states and localities. Congress rejected this approach.

The STAA authorized the major highway safety programs which are also funded from the Highway Trust Fund. The FY 1982 appropriations act redirected the program toward four high priority areas for grants: alcohol safety, emergency medical service, police traffic service and traffic records. By law, 20% of the grants must be used for enforcement of the 55MPH speed limit.

FY 1983 Budget Proposal: The Administration proposes a federal aid obligation ceiling of $7.7 billion, a decline of $300 million or 3.8%. The highway interstate transfer grant program which had been funded by general revenues would be funded from the Highway Trust Fund, and thus be included in the obligation ceiling. The program would be cut from $288 million in FY 1982 to $150 million in FY 1983, a decrease of 48%. The Appalachian Development Highway System, funded from general revenues this year through the Appalachian Regional Commission which the Administration wants to terminate would be moved to the Federal Highway Administration and receive $80 million from the Highway Trust Fund. The reduced highway funds would be targeted on the interstate and primary highway systems. A lower priority would be placed on secondary and urban highways. An increasing emphasis will be placed on rehabilitation and a lower priority on new construction.

The state and community safety grants program would be cut from the FY 1982 level of $92.5 million to $77 million, a decrease of 17%.

Total outlays for highways and highway safety programs would remain steady at the level of $8.5 billion. Commitments made years earlier, however, govern the level of highway outlays in any given year. Budget authority for highways and highway safety programs which measures future trends in highway programs would decrease from $8.8 billion in FY 1982 to $8.2 billion in FY 1983, excluding the Appalachian Development Highway System.

Impact on the States: The drop in highway spending will strain the ability of states to preserve existing road systems and begin new construction projects. States will face increased pressure from citizens to step in and increase their own funded programs to compensate for federal cutbacks. The impact of the budget on the types of highways will depend on the authorizing legislation Congress passes this year.

The lower obligation ceiling will have a differential impact among states. States which have been slow to use the federal funds available to them would be disadvantaged. As they now raise enough monies to match federal funds, the lower obligation ceiling may prevent them from starting new projects.

Outlook: Congress is unlikely to approve incorporation of the all non-Interstate highway programs in a turnback as envisioned in the President's federalism initiative. Some blocking of programs and increased flexibility and transferability among categories may be secured as a result of the pressure to reduce funding and give states a greater role in the program. Many transportation advocates within the public and private sectors may support a substantially expanded federal program funded by increased user charges but affirmative action by Congress in the absence of Administration support is improbable. Some increase in the obligation ceiling might be expected, since the $300 million reduction actually translates into a $530 million cut when Appalachian highways and highway substitute projects under the Interstate transfer provision are placed under the obligation ceiling. Some resistance can be expected to those specific reductions, as well.

Support within the Congress for highway safety is strong. Thus, efforts to reduce funding within the Federal Highway Administration for safety construction programs and within the National Highway Traffic Safety Administration for supporting state safety efforts can be expected to meet resistance.

PUBLIC TRANSPORTATION

The STAA which expires at the end of FY 1982, authorizes the major federal public transportation programs: urban mass transit formula grants for capital projects and operating assistance, urban mass transit discretionary capital assistance, rural public transportation formula grants and interstate substitutions. The rural public transportation program serves communities with populations under 50,000. The interstate substitution program allows state and local governments to jointly withdraw non-essential large urban interstate highway projects and receive an equal amount of federal funds for mass transit or highway projects. In FY 1981 the program was divided into highway and transit components. In the past most of the substitutions have been for transit projects, but recently an increasing percentage of the funds have been devoted to highways. All public transportation and highway substitution projects are currently funded from general revenues.

The Reagan Administration favors phasing out public transportation operating assistance programs, but continuing to fund capital programs. The Administration sent Congress authorizing legislation last year that would end urban mass transit operating assistance programs over a three-year period beginning in FY 1983. The plan focused capital assistance on preserving and rehabilitating existing transit rail and subway systems, no funds for new rail or subway starts, and a continued bus purchase program. Congress took no action on the Administration's proposal.

The FY 1982 budget may have been a watershed year for federal public transportation programs. Federal support increased through FY 1981, but the Reagan Administration opposition to operating assistance and desire to cut domestic programs resulted in a reversal for FY 1982. Urban capital assistance dropped by $331 million, operating assistance by $69 million even before the first year of the planned phase out, and rural transit assistance by $4 million.

<u>FY 1983 Budget Proposal:</u> The Administration proposes to cut urban formula grants for operating and capital assistance by 38% in the first year of the planned three-year phase out. Total program funds would include:

- $440 million for the Tier I program of Section 5 which funds all urban areas on the basis of population density;
- $130 million for the Tier II program for larger urban areas; and
- $70 million for the Tier III program for urban areas with rail and subway systems.

The total program would shrink to $275 million in FY 1984 and zero in FY 1985.

The budget would cut total capital assistance programs by 8% from $2.5 billion in FY 1982 to $2.3 billion in FY 1983. The Section 3 urban discretionary grants programs would include:

- $520 million for bus and bus-related capital grants,
- $861 million for rail transit facility modernization and rehabilitation projects, and
- $120 million to complete operable segments of new start rail or subway projects which are covered by formal letters of intent.

Tier IV of Section 5 which provides for formula grants for bus and bus facility capital projects would receive $375 million, an increase of $45 million. The public transportation interstate transfer program would receive $400 million, down from $538 million in Fy 1982.

The rural public transportation formula grant program would receive no new budget authority. The program will continue on $43 million carried over from previous years.

For the first time funding for the Washington Metro subway system is included in the UMTA capital budget at a level of $100 million. Funding for the program is contingent upon the District of Columbia, Maryland and Virginia establishing stable and reliable local sources of revenue to support the system. Total outlays for the Urban Mass Transit Administration would shrink from $3,855 in FY 1982 to $3,742 in FY 1982 to $3,155 in FY 1983.

Impact on the States: Federal operating assistance which is slated for elimination-now covers about 15% of the operating costs of transit systems. For many systems, however, the percentage is much higher. Transit systems will be faced with the choices of raising fares, cutting service, seeking government assistance from non-federal sources, or all three. State governments will feel increased pressure to support local-or-state operated transit systems. The amount of pressure will vary between states depending on the size of transit systems, their dependence on federal revenues and their ability to raise more funds locally, either through the farebox or local governments.

Several cities such as Houston and Los Angeles are planning to start new rail commuter or subway lines. With reduced capital funding, plans will have to be abandoned or alternate financing found elsewhere. Cities seeking help on these projects will likely turn to states for assistance.

Rural public transportation programs may not survive the elimination of federal assistance. States will have to assist these systems or many will disappear.

Outlook: Response to the Administration's public transportation policy will be mixed. Members of Congress representing the largest urban areas are likely to seek a compromise that will guarantee a stable level of support for transit, whether or not operating assistance is cut. Others are likely to oppose any change in the current mix of capital and operating aid, whether or not the program dollars are reduced. Still others will oppose cuts in the program and the phase out of transit operating assistance.

AIRPORT AND AIRWAYS

The Airport and Airways Development Act (ADAP) passed in 1970 and reauthorized in 1976 provided for airport planning and development grants through FY 1980. The program is funded by revenues from the Airport and Airways Trust Fund which receives income from taxes on passenger tickets, and other minor excise taxes. The trust fund also pays for part of the budget of the Federal Aviation Administration (FAA). Congress refused to reauthorize the program in 1980, bringing the program to a halt in October 1980. The budget reconciliation bill passed in August 1981 included an FY 1981 obligation ceiling of $450 million for ADAP, the same level as FY 1980 but considerably below the $640 million level of FY 1979. Since it was not reauthorized last year, the program again came to a halt in October 1981. The balance in the trust fund at the beginning of FY 1982 is estimated to be $4.7 billion.

The Reagan Administration in 1981 proposed a reauthorization of ADAP with one major new feature: the 41 largest commercial airports would become ineligible for funds on the theory that those airports could directly raise funds from the commercial airlines using their facilities. These airports would be "de-federalized." Disagreement over the de-federalism proposal, controversy over the ticket tax level, disagreement over the amount of trust fund revenue used to support the FAA, and controversy over the Administration's proposed general aviation fuel taxes all resulted in the failure to reauthorize ADAP last year.

FY 1983 Budget Proposal: The Administration will seek ADAP reauthorization again this year. The legislation will request an increase in general aviation user fees and deposit of the receipts in the Airport and Airways Trust Fund. Pending reauthorization, the budget proposes a \$450 million obligation ceiling on ADAP spending. The Administration also proposes using \$2.9 billion from the trust fund for Federal Aviation Administration expenses: \$2.0 billion for operating expenses, \$725 million on a full funding basis for facilities and equipment and \$134 million for research engineering and development. This total is \$1.7 billion more that the \$1.1 billion dedicated to FAA expenses in FY 1982. Some of the funds for facilities and research would be spent on the first phase of the newly proposed air traffic control system.

Impact on the States: An obligation ceiling of \$450 million for ADAP for three years in a row would mean a shrinking of funds when adjusted for inflation. The tentative federalism plan to return all airport development responsibilities to the states and localities in FY 1984 would also put increased responsibility and fiscal pressure on them. A major impact would occur if the Administration proposes and Congress accepts a plan to de-federalize major airports. States would then be faced with either providing funding for the airports or allowing local airport authorities to increase their user charges and taxes.

Outlook: The two-year-old controversy over de-federalizing the nation's busiest hub airports has contributed to congressional inaction on extending ADAP. Other complications include the issue of granting authority for local entities to assess fees to finance airport improvements; the proposed increase in aviation user charges to finance a greater share of the airport and airway system's operational costs, while reducing capitol funding and the proposed use of existing trust fund development funds to finance 85% of the Federal Aviation Administration's current operating costs. Congress will have extreme difficulty in achieving a consensus on extension of the program.

RAILROADS

The Staggers Act of 1980 allowed freight railroads to speed the process of abandoning unprofitable branch lines. The Northeast Rail Service Act of 1981 allowed Conrail to plan for abandonment of several thousand miles of its system in 90 days as opposed to the normal much longer time frame. As abandonments increase, many states have established programs to find alternate ways to keep freight service operating over lines they consider essential. The local rail service assistance program provides formula grant money to states to subsidize freight rail service, purchase and rehabilitate rail property, find alternate operators for abandoned branch lines, and take other steps to preserve freight service. In 1981, the Reagan Administration proposed ending this program and rescinding leftover funds. Congress objected and the program, which received $80 million in FY 1980, is continuing in FY 1982 on $35 million deferred from FY 1981.

Ten years after its birth Amtrak manages to collect only about half its operating costs from ticket sales, with the federal government paying most of the rest. The Reagan Administration philosophy is to reduce the federal subsidy quickly. In FY 1981 the Administration proposed a reduction of 39%, but Congress reduced funding by only 17% to $735 million. States can contract with Amtrak to run trains if states agree to subsidize the service. Currently eight states contribute to the operation of these Section 403(b) trains: California, Illinois, Maryland, Michigan, Minnesota, Missouri, New York and Pennsylvania. For FY 1982, the state share for these trains was increased to 45-65% of "short-term avoidable costs," up from 20-50%.

FY 1983 Budget Proposal: The Administration proposes to use $20 million in unobligated prior year funds for the Local Rail Service Assistance program, a drop of $15 million or 43% from FY 1982. No funds will be requested for future years. Amtrak funding would be cut to $600 million from $735 million, an 18% reduction. States would be required to increase their contributions to 403(b) trains to 100% of "long term avoidable costs." The Administration expects Amtrak would continue to operate a national rail passenger system with decreased federal support. The Northeast Corridor Rehabililitation Project would receive $115 million, a cut of 32% from FY 1982.

Impact on the States: The cut in the Local Rail Assistance Program would make it difficult for any state to run an extensive program. The program has a formula base which guarantees each state a minimum of 1% of program funds. Elimination of the program in future years would force the closing of many state rail offices.

The Administration estimates that the increase in state costs for the 403(b) trains would be $24 million, which may force some of the eight states to drop out of the program.

Outlook: The Administration proposed eliminating the Local Rail Assistance Program last year and redirecting its appropriation to other functions. Congress disapproved the elimination but did agree to defer $35 million of the FY 1981 money into FY 1982. The popularity of the program will make this a difficult cut to make.

Amtrak and supporters of a national rail passenger system were successful in fending off efforts to reduce the network last year.

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Arguments that setting funding at $613 million would allow Amtrak to operate trains only in the Northeast Corridor were persuasive then, and can be expected to be reiterated.

TRANSPORTATION USER FEES

Users of transportation networks often pay fees or taxes that support the systems. The federal government and all state governments collect taxes on the retail sale of motor fuel, and in most cases the revenues are dedicated to pay for highway and road programs. In the 1970s airline passengers paid a ticket tax that was dedicated to pay for airport development and operation of the national airways system. Companies using the inland waterways now have a fuel tax that partly offsets the cost of maintaining the system. The Administration believes users of government services should pay for them to the greatest extent possible. In 1981 the Administration introduced legislation to increase a number of transportation user fees. None of these proposals passed Congress, although committees in both chambers passed bills to impose port development and maintenance charges.

FY 1983 Budget Proposal: The Administration again proposes a number of new or revised charges for individuals and companies that use the nation's transportation system. The user fee proposals would:

- increase the airline passenger ticket tax from 5% to 8% and place the revenues in the Airport and Airways Trust Fund;

- impose a 12 cents a gallon tax on general aviation gasoline fuel in 1982, rising to 20 cents by 1987, and tax general aviation jet fuel starting at 14 cents a gallon in 1982 and rising to 22 cents in 1987, with revenues deposited in the Airports and Airways Trust Fund;

- authorize the Secretary of Transportation to initiate fees to recover 100% of the costs of Coast Guard services that provide benefits to individuals or enterprises;

- raise the fuel tax now paid by users of the inland waterway system;

- initiate navigation user fees for dredging harbor channels and constructing and maintaining other facilities for ocean and Great Lakes traffic.

Impact on the States: There would be little direct dollar or administrative impact on the states. However, the adoption of user fees could have an impact on transportation network use patterns and affect the economies of several states. To the extent that states use a similar tax base to finance their share of these programs, increases at the federal level would affect their ability to raise additional revenues.

Outlook: A strong burden of proof will be placed on the proponents of increased user fees to demonstrate that an improved system or program will result. A readjustment of costs--without enhancing the services paid for the fees--will be met with strong resistance from the affected groups and their supporters in the Congress.

Appendix

Congressional Budget Process

Since 1975, congressional consideration of the President's budget has been governed by the provisions of the Congressional Budget and Impoundment Control Act.

The initial step in the process is the submission to Congress of the President's budget in mid-January. Shortly after it is submitted, the budget committees in the House and Senate hold hearings on the spending proposals and the economic assumptions on which they are based.

A number of separate actions take place concurrently with budget committee hearings. The standing committees advise the budget committees on programs and outlays likely to be authorized during the year. The Joint Economic Committee advises on the economic outlook and appropriate fiscal policy. The Congressional Budget Office reviews the budget, makes economic projections, and then files a report dealing with national economic policy, alternative total budget levels, and national budget priorities.

Based on these materials and the results of their own hearings, the budget committees recommend a first concurrent resolution on the budget to their respective houses by April 15. These resolutions cover the recommended levels of budget authority and outlays in total and for each of the major functions in the budget (but not for individual programs), and the deficit, revenues and expenditures, and changes in federal debt implied by the spending and taxing decisions.

The first budget resolution establishes targets for budget authority and outlays. These budget targets, which represent a congressional determination of appropriate fiscal policy and national budget priorities, guide Congress in its subsequent spending and revenue decisions. However, the allocations for each function are not binding on Congress at this stage. Using the normal procedures for enacting a resolution, including a conference committee to reconcile differences between the two houses, Congress approves the first resolution by May 15.

May 15 is also the deadline for reporting legislation authorizing new spending. Authorization bills reported after that date, with a few exceptions, are subject to a point of order unless an emergency waiver is granted.

In a statement that accompanies the first budget resolution, the totals for functions (e.g., community and regional development, national defense) are divided among the committees of the House and Senate, so that each committee is working against a known, but nonbinding, ceiling.

Under the budget process, Congress must complete action on bills and resolutions providing new budget authority and new spending authority by one week after Labor Day. Exceptions are made for appropriation bills that cannot proceed until authorizing bills are passed. Exceptions also arise when Congress is unable to agree on particular bills, such as when an issue like abortion or school busing holds up appropriation bills. In this case, a "continuing" appropriation bill is passed as a stop-gap measure to allow programs to function until an appropriation bill is enacted. For FY 1982, there have been three continuing appropriation bills. The first enacted on October 1, 1981, kept the federal government and federal programs operating for six weeks, the second for three weeks and the third, covering three of the required 13 appropriation bills, is due to expire on March 31, 1982.

Congress is scheduled to pass a second budget resolution by September 15. This resolution covers the same subjects as the first one, but it is binding in the sum total of revenues and expenditures. The resolution reflects updated estimates of both expenditures and revenues, as well as any program decisions that have changed since the first resolution.

The schedule calls for Congress to complete action on "reconciliation" bills and resolutions by September 25. Reconciliation measures alter previously passed authorization and apppropriation bills to conform to the spending limits set by the budget resolution. Reconciliation was originally conceived as a part of the second budget resolution, but for FY 1981 and FY 1982 Congress attached reconciliation instructions to the first resolution.

All action on the budget should be completed by October 1, when the federal government begins its new fiscal year.

COMPARATIVE BUDGET TOTALS:

FY 1981-1983

BUDGET OUTLAYS AND BUDGET AUTHORITY BY FUNCTION
FY 1981 - 1983 (in billions of dollars)

	FY1981 Actual	FY1982 Est.	FY1983 Budget	Percent Change FY82-83
Revenues	599.3	626.8	666.1	6.3
Budget Authority	718.4	765.5	801.9	4.8
Outlays	657.2	725.3	757.6	4.5
Surplus (+)/Deficit(-)	-57.9	-98.6	-91.5	-7.2
050—National defense:				
Budget Authority	182.4	218.9	263.0	20.1
Outlays	159.8	187.5	221.1	17.9
150--International affairs:				
Budget Authority	24.8	18.5	18.1	-2.2
Outlays	11.1	11.1	12.0	8.1
250—General science, space and technology:				
Budget Authority	6.5	7.0	7.8	11.4
Outlays	6.4	6.9	7.6	10.1
270--Energy:				
Budget authority	6.8	4.8	4.3	-10.4
Outlays	10.3	6.4	4.2	-34.4
300--Natural resources and environment:				
Budget authority	11.1	10.0	8.4	-16.0
Outlays	13.5	12.6	9.9	-21.4
350--Agriculture:				
Budget authority	6.6	9.6	6.9	-28.1
Outlays	5.6	8.6	4.5	-47.7
370—Commerce and housing credit:				
Budget authority	6.5	6.3	3.4	-46.0
Outlays	3.9	3.3	1.6	-51.5
400--Transportation:				
Budget authority	24.9	21.0	19.1	- 9.0
Outlays	23.4	21.2	19.6	- 7.5
450--Community and regional development:				
Budget authority	8.1	6.6	6.7	1.5
Outlays	9.4	8.4	7.3	-13.1
500--Education, training, employment and social services:				
Budget authority	30.6	23.5	18.8	-20.0
Outlays	31.4	27.8	21.6	-22.3
550--Health:				
Budget authority	68.9	79.2	77.8	- 1.8
Outlays	66.0	73.4	78.1	6.4
600--Income security:				
Budget authority	249.9	252.3	257.6	2.1
Outlays	225.1	250.9	261.7	4.3
700--Veterans benefits and services:				
Budget authority	23.2	24.8	25.7	3.6
Outlays	23.0	24.2	24.4	.8
750--Administration of justice:				
Budget authority	4.3	4.3	4.5	4.7
Outlays	4.7	4.5	4.6	2.2
800--General government:				
Budget authority	5.1	5.2	5.3	1.9
Outlays	4.5	5.1	5.0	-2.0
850--General purpose fiscal assistance:				
Budget authority	6.3	6.4	6.7	4.7
Outlays	5.9	6.4	6.7	4.7
900—Interest:				
Budget authority	82.5	99.1	112.5	-
Outlays	82.5	99.1	112.5	-
920--Allowances:				
Budget authority	-	-.6	-1.2	-
Outlays	-	-.6	-1.2	-
950—Undistributed offsetting receipts:				
Budget authority	-30.3	-31.5	-43.5	-
Outlays	-30.3	-31.5	-43.5	-

Glossary

APPROPRIATION-An act of Congress that allows federal agencies to incur obligations and make payments from the Treasury for specific purposes. An appropriation usually follows enactment of authorizing legislation and is the most common means of providing budget authority.

AUTHORIZATION-Basic substantive legislation enacted by Congress that sets up or continues the legal operation of a federal program or agency. Such legislation is normally a prerequisite for subsequent appropriations, but does not usually provide budget authority (see below).

BUDGET AUTHORITY-(BA)-Authority provided by law to enter into obligations that will result in immediate or future outlays. It may be classified by the period of availability (1-year, multiple-years, no-year), by the timing of congressional action (current or permanent), or by the manner of determining the amount available (definite or indefinite). The basic forms of budget authority are:

Appropriations-(See Above)

Borrowing authority-statutory authority not necessarily provided through the appropriations process, that permits federal agencies to incur obligations and to make payments from borrowed moneys.

Contract authority-statutory authority not necessarily provided through the appropriations process, that permits Federal agencies to enter into contracts or incur other obligations in advance of an appropriation.

BUDGET RECEIPTS-Money, net of refunds, collected from the public by the federal government through the exercise of its governmental or sovereign powers, as well as through gifts, contributions and premiums from voluntary participants in federal social insurance programs closely associated with compulsory programs. Excluded are amounts received from strictly business-type transactions (such as sales, interest or loan repayments) and payments between government accounts (See offsetting receipts.)

BUDGET SURPLUS OR DEFICIT-The difference between budget receipts and outlays.

CONCURRENT RESOLUTION ON THE BUDGET-A resolution passed by both Houses of Congress, but not requiring the signature of the President, setting forth targets or binding federal budget totals for the Congress.

CONTINUING RESOLUTION-Legislation enacted by Congress to provide budget authority for specific ongoing activities when a regular appropriation for such activities has not been enacted by the beginning of the fiscal year. The continuing resolution usually specifies a maximum rate at which an agency may incur obligations, based on the rate of a prior year, the President's request, or an appropriation bill passed by either or both Houses of Congress.

CONTROLLABILITY-In the President's budget this refers to the ability of the President to control budget authority or outlays during a fiscal year without changing existing substantive law. The concept "relatively uncontrollable under current law" includes outlays of open-ended programs and fixed costs, such as interest on the public debt and social security and veterans benefits, and outlays to liquidate (pay for) prior-year obligations.

CURRENT SERVICES ESTIMATES-Estimated budget authority and outlays for the upcoming fiscal year at the same program level as and without policy changes from the fiscal year in progress. To the extent mandated by existing law, estimates take into account the budget impact of anticipated changes in economic conditions (such as unemployment or inflation), beneficiary levels, pay increases, and benefit changes. The Congressional Budget Act of 1974 requires that the President transmit current services estimates to the Congress. The current services estimates for 1981 are published in Special Analysis A of the 1981 Budget.

DEFERRAL-An action by the President that temporarily withholds, delays or precludes the obligations or expenditure of budget authority. A deferral must be reported by the President to Congress in a deferral message and can be overturned if either House passes a resolution disapproving it. A deferral may not extend beyond the end of the fiscal year in which the message reporting it is transmitted to Congress.

ENTITLEMENT PROGRAM-Any program whose enabling legislation requires the payment of benefits to any person or government meeting the requirements established by such law, e.g., social security benefits and veterans' pensions. Section 401 of the Congressional Budget Act of 1974 places certain restrictions on the enactment of new entitlement authority.

FISCAL YEAR-The yearly accounting period for the federal government, which begins on October 1 and ends on the following September 30. The fiscal year is designated by the calendar year in which it ends; e.g., fiscal 1933 begins on October 1, 1982 and ends September 30, 1983. (From fiscal year 1884 to fiscal year 1976, the fiscal year began on July 1 and ended on the following June 30.)

FUNCTION (FUNCTIONAL CLASSIFICATION)- The functional classification is a means of presenting budget authority, outlay and tax expenditure data in terms of the principal process that the federal programs are intended to serve (e.g. national defense, health) regardless of the federal agency administering the program.

GRANTS-IN-AID-For the purposes of the budget, grants-in-aid consist of budget outlays by the federal government to support state and local programs.

LOAN GUARANTEE-An agreement by which the government pledges to pay part or all of the principal and interest of a loan to the lender or holder of a security if the borrower defaults. If it becomes necessary for the government to pay part or all of the loan principal or interest, the payment is an outlay. If not, then the loan guarantee does not affect federal spending and appears in the budget only as budget authority.

OBLIGATIONS-Amounts of orders placed, contracts awarded, services rendered or other commitments made by federal agencies during a given period, that will require outlays during the same or some future period.

OFF-BUDGET FEDERAL ENTITIES-Organizational entities, federally owned in whole or in part, whose transactions belong in the budget under current budget accounting concepts but that have been excluded from the budget total under provisions of law. Information on these entities is presented in various places in the budget documents.

OFFSETTING RECEIPTS-Collections deposited in receipt accounts that are offset against budget authority and outlays rather than being counted as budget receipts. These collections are derived from other government accounts or from the public through activities that are of a business-type or market-oriented nature. Offsetting receipts are classified as (1) intragovernmental transactions or (2) proprietary receipts from the public.

OUTLAYS-Values of checks issued, interest accrued on the public debt or other payments made, net of refunds and reimbursements.

RESCISSION-Enacted legislation canceling budget authority previously provided by the Congress.

RECONCILIATION PROCESS-A process used by Congress to reconcile amounts determined by tax, spending and debt legislation for a given fiscal year with the ceilings enacted in the second required concurrent resolution on the budget for that year. Section 310 of the Congressional Budget Act of 1974 provides that the second required concurrent resolution on the budget, which sets binding totals for the budget, may direct committees to determine and reconform with the binding totals for budget authority, revenues and the public debt.

Such changes are incorporated into either a reconciliation resolution or a reconciliation bill.

Reconciliation Bill-a bill, requiring enactment by both House of Congress and approval by the President, making changes in legislation that has been enacted or enrolled.

Reconciliation Resolution-a concurrent resolution, requiring passage by both Houses of Congress but not the approval of the President, directing the Clerk of the House or the Secretary of the Senate to make specified changes in bills or resolutions that have not yet reached the stage of enrollment.

SUPPLEMENTAL APPROPRIATION-An appropriation enacted as an addition to a regular annual appropriation act. Supplemental appropriation acts provide additional budget authority beyond original estimates for programs or activities (including new programs authorized after the date of the original appropriation act) for which the need for funds is too urgent to be postponed until the next regular appropriation.

TAX EXPENDITURES-Losses of tax revenues attributable to provisions of the federal income tax laws that allow a special exclusion, exemption or deduction from gross income or provide a special credit, preferential rate of tax or a deferral of tax liability affecting individual or corporate income tax liabilities.

TRUST FUNDS-Funds collected and used by the federal government for carrying out specific purposes and programs according to terms of a trust agreement or statute, such as the social security and unemployment trust funds. Trust funds are not available for the general purposes of the government. Trust fund receipts that are not anticipated to be used in the immediate future are generally invested in interest-bearing government securities and earn interest for the trust fund.

UNIFIED BUDGET-The present form of the budget of the federal government, in which receipts and outlays from federal funds and trust funds are consolidated. When these fund groups are consolidated to display budget totals, transactions which are outlays of one fund group for payment to the other fund group (i.e., interfund transactions) are deducted to avoid double counting. Transactions of off-budget federal entities are not included in the unified budget. (See OFFSETTING RECEIPTS and OFF-BUDGET FEDERAL ENTITIES.)

INCOME DISTRIBUTION

Representative REUSS. Thank you, Governor Matheson, and thanks to the whole panel.

Let me start out with the point just made by the Governor of Utah. As I observed before, all of you witnesses are Democrats and while your philosophy may stress one or another element of the party's history, I would feel quite confident that you all include Thomas Jefferson as one of your heroes. I don't see any dissent from that, and I think Jefferson is the man who put the idea of equality into the Declaration of Independence. That was his idea and let me now state the question I have.

It would seem to me that the combination of current budget arrangements and of certain applications of the New Federalism would, as Governor Matheson has just testified, result in the diminution of grants and programs for the needy. I would also guess that States would make a valiant effort to bridge that gap by their own taxes, but that it would not be wholly successful because of limitations on State taxing ability, and that the State taxes, to the extent that they are levied, would be what are generally thought of as regressive taxes—State, local, and property taxes on the homeowner, State and local sales taxes on the consumer—as opposed to the more progressive Federal income and State taxes which are being, as you all know, rapidly diminished.

Don't both of those factors make our distribution of income in this country, which in the last 10 years—as I regret to say—move in a way that disadvantages middle income and moderate income and poor people, and greatly advantages those at the top of the income scale? Aren't these two elements—the budget operations and the New Federalism—likely to make income distribution more unfair?

Governor LAMM. I would remind you that Jefferson's key philosophy was to keep Government close to the people, and a lot of us feel that you can really achieve this goal by New Federalism. However, there are certain income distribution programs and AFDC, food stamps, and medicaid that are in fact national responsibilities and ought to be federally administered. I think, however, in one area we find broad support among Governors that in a number of the other categorical programs the Congress doesn't realize how we suffer. There are 1,259 mandates that are put into some four or five hundred categorical programs. There's 43 categorical programs in the public health area alone. You have to understand that we should be able to draw lines between those overriding Federal income distribution policies and areas that the Federal Government should have never gotten into in the first place.

FEDERAL RESPONSIBILITY

Representative REUSS. I like what I hear about the National Governors' Association response and counterproposal because, if I hear right, it says that the New Federalism should stress State and local management of and responsibility for programs, but that the Federal Government has an important task of fiscal equalization which a State can't as well accomplish because if a State imposes too high a regressive tax people will leave that State. Is my perception of what the NGA is up to correct?

Governor MATHESON. Mr. Chairman, your perception is sound. We have recognized that no matter how carefully we try to adjust and be fair on a State-by-State basis, the wealth distribution is just not that way in fact. And so we envision, if the New Federalism approach on the swap comes about and we end up with a bundle of programs, we simply would have to have a trust fund at the Federal level which would take into consideration that great disparity.

Now how you do that, what formula you would use, we have not yet decided, but the ACIR has been studying this matter for many years and many States have very sophisticated formulas to do that and we want to address that problem and we do want to address that disparity as a part of the federalism.

BLOCK GRANTS

Representative REUSS. Well, I encourage you on that because I think you're on the right track and I also, Governor Lamm, have no disagreement with you at all about getting rid of overfussy, oversubdivided Federal programs. A dozen years ago when a Democratic administration proposed here a very worthy program to help States and communities get rid of rats, I and Senator Mathias and some others, instead made a block grant of that program so that if a State had a rat problem, fine, but if its problem was one of pigeons or starlings or other vectors it could use it for that; and I think the general idea of simplifying and consolidating block grant programs is something that you can't beat the drums on too much as far as I'm concerned.

Congressman Brown.

FEDERAL CUTBACKS

Representative BROWN. Governor Carey, our former colleague here, I want to address my question primarily to you, but I also would like to ask some of the other gentlemen as well.

To be sure, Federal aid to States has been cut back. However, what we are really talking about is declining the rate of increase in the Federal aid to the States and not some drastic reduction in the number of dollars flowing from Washington to Albany.

In your annual budget message of 1982–83, this shows in fiscal 1981–82 the State of New York received some $7,237,000 in Federal grants. In fiscal year 1982–83 Federal grants to the State of New York will be $7,583,000. That's a growth of about 5 percent in Federal grants to your State over the last year.

I understand that some of this increase may be due to increased Medicaid payments, but it's not really a question of budget cuts causing Federal aid to your State to fall; it's a question of reducing the rate of increase, isn't it?

I understand that many programs have been cut, some may be that shouldn't have been—I mean it's a judgment that you might not have made if you had the choice in your own State. But the bottom line is the State of New York will have its Federal grants increased about 5 percent. That's what I get from page 4 of your budget message.

Governor CAREY. That's correct; the effort has been to limit the rate of growth, but I think you've got to go one step beyond the 1982–83 budget message to see the effect of the cuts that have not translated into Federal aid yet because, as Governor Matheson said, our experience in block grants last year was memorably bad. We couldn't figure out the level we were being given because you remember in Congress you didn't really pass a budget until October and we couldn't figure out what the level of grants were.

We assumed the old level and the 5-percent increase basically was the programs being cut this year. What you're seeing there are the government-to-government grant levels because you have left out, and it's not reflected in my budget, the entitlement cuts. The entitlements cuts are those going to individuals. Those entitlement cuts and transfer payment cuts will bring us up to $2 billion.

Representative BROWN. But I understand that your fiscal year runs from April 1 to March 31.

Governor CAREY. That's right.

TAX CUTS

Representative BROWN. So that 1982–83 budget for New York includes the Federal budget cuts for fiscal year 1982, the one that we passed last year. Of course, as you know, you more than perhaps some of the other Governors here, what Congress did was cut the amount of programs and then left strings on them. The proposal from the President was to cut the amount in the program and then cut the administrative costs also, which was not quite, I guess, what was originally asked.

Let me go on to talk about your own experience in New York for a minute because you're critical of the President's tax cuts and his cuts in spending.

Didn't you cut the marginal tax rates on earned individual income in New York beginning in 1977? Weren't those cuts rather substantial over the years? I note that in 1978 the highest marginal rate was 15 percent with a 25-percent surcharge at 17.5 percent as the top marginal rate. Now in 1977, 1978, and 1979, you cut that top marginal rate on earned individual income down to a present level of, as I understand it, 10 percent. In other words, you cut marginal tax rates by 45 percent in New York and yet you're critical of the President's tax cuts which are only half as large on the Federal level.

Why is it good economic policy in Albany and not good economic policy in Washington?

Governor CAREY. Because in New York we first cut the budget and then we cut the taxes. Since 1975, a flat year when we were in very serious trouble and came to you for help——

Representative BROWN. I have my New York necktie on.

Governor CAREY. I noticed you have the New York necktie on which used to be known as a noose. [Laughter.]

Representative BROWN. I thought it was a memorial necktie.

Governor CAREY. We carefully put in budget restraints and restrained the rate of growth at half the rate of inflation and we did that and then took our medicaid program and cut $2.3 billion in medicaid and, if I may say so, these were very wise cuts that didn't hurt the medicaid recipient and institutions. We achieved those savings. We had to put in those savings to spur and stimulate our economy.

We felt that the marginal tax rate you point out, 15 percent of the higher incomes, was confiscatory and counterproductive to attracting talent, technology, and leadership to the State. We brought in the private sector and labor people and said, "We've got to get out of this high tax economy we're in," and we came to that and targeted it. As well as, at the same time, reducing marginal tax rates on the people more fortunate, we also removed a great number of low income people from the tax rolls with a balanced tax cut.

Representative BROWN. Isn't that precisely what was undertaken at the Federal level here in Washington?

Governor CAREY. No.

Representative BROWN. Where they tried to cut the tax rates on the folks at the high income but across the board at the same percentage rate and cut the increase in spending by 5 percent rather than the cost-of-living increase so that there was a cut in real growth of the budget? I'm confused.

Governor CAREY. I'd like to draw the distinction as the Wall Street Journal editorial did and show what New York did was get its budget under control and generate a real surplus, and then distribute that surplus. You don't have a surplus. All you're sharing with us is the deficit and increasing that deficit is our concern.

Furthermore, something that hasn't been discussed here is that New York is trying to do its utmost to target these tax reductions and target the improvements we are making into the recessed areas to create jobs.

Representative BROWN. That's also present in the enterprise zones' proposal.

Governor CAREY. The enterprise zones are in place in New York. We don't need a program of enterprise zones.

Representative BROWN. You seem to criticize the President for trying to undertake what you have already undertaken in the State of New York. That's where I come off a little confused.

Governor CAREY. In February 1981 at the Governors' conference in the East Room of the White House I raised my voice and said to the President, pleaded with him, "Mr. President, please don't put through the Kemp-Roth tax cut bill until you have the budget under control because you will drive interest rates up and make it impossible for us to get this economy into a progressive system," and he immediately said, "I'm going to do it."

Representative BROWN. You did it in New York. The year before the tax cuts were enacted in New York the unemployment was above the national average. The New York unemployment rate was 2.6 percent higher than the national average. After you enacted the tax cuts, the gaps between New York and the national average began to drop dramatically. You no longer had a city that was in as deep trouble because first the Federal Government with its deficits had come in and helped bail out the city, so that you had in effect a change in your policy that stimulated the growth of the economy and it helped to balance out the situation of the city of New York, didn't it?

Governor CAREY. That's right.

Representative BROWN. And increase the opportunity for the city of New York to pay off its debt, its heavily bonded debt, and that is a deficit operation. You also had a deficit, didn't you, at the State level, if you considered the bondings that you undertook? This business about States not being allowed to have a deficit operation is an interesting concept, but technically States are allowed to sell bonds and so are municipalities, and so technically they do not operate on a balanced budget; they operate on borrowed money, and in the case of New York City, even more borrowed money because you were using some of it for operation.

Governor CAREY. Yes, and this year again we are trying to reduce our—we brought our borrowing down enormously. We've gone from short-range to long-range borrowing. We capped our borrowing, finished the bonding we were permitted and paid it off.

Representative BROWN. And you paid it off by the growth of the State because you cut the tax rates; is that correct?

Governor CAREY. Right, but our total debt commitment was reduced. Now what's going to happen, in May you're going to have the Secretary of the Treasury coming up to ask you for a $1,079,000,000 new debt limit. We couldn't do that in New York.

Representative BROWN. But you did ask us to help you. Let me go on to another point.

Governor CAREY. But I want to keep the distinction clear.

Representative BROWN. I have one more question I have time to ask.

Governor CAREY. We cut the budget and then we cut the taxes. We didn't cut the budget on the backs of the poor.

Representative BROWN. The President is also cutting the budget and that seems to be something to which there's some objection.

I'm interested in your recent announced plan to finance public education in New York. You're asking for an increase in the sales tax with offsetting cuts in income taxes. The New York Times reports an aide to the Governor said:

> Mr. Carey preferred a sales tax increase to an income tax increase because businesses the State was seeking to lure were particularly opposed to income tax increases. Income tax reductions have been a cornerstone of the Governor's economic development policies.

Is this an accurate reflection of why the sales tax was increased? It's very interesting because the JEC study found that States that taxed consumption grow faster than States that tax income. Governor King made a reference to that. Don't misunderstand me. I'm not suggesting tax cuts alone can turn around every State experiencing economic misfortune. Many other variables must come into play. What's interesting is that New York is choosing the tax consumption rather than income because you feel this will lure business into the State and improve the State economy and that's essentially what we're trying to do in Washington. I'm trying to figure out whether you taught Jack Kemp or Jack Kemp taught you.

Governor CAREY. He lost the lesson book somewhere along the way. Let me point out that I favor the consumption at Federal level. We need a tax on consumption of motor fuel nationwide to support mass transit and improvements in our road and highway system, and Secretary Lewis is advocating that but the Congress is not picking it up.

I also think we should have a tax on consumption on the import of foreign fuel and perhaps pay for the defense budget. So I'm advocating some increased taxes at the Federal level to cut this deficit.

Something that nobody has discussed today—we need to talk about poor and middle income people. The No. 1 need is shelter and housing. We have no housing program in the country today.

Representative BROWN. But you apparently would not tax income in your State but would rather tax consumption, so are you suggesting that we tax consumption at the Federal level?

Governor CAREY. Yes.

Representative BROWN. A fuel tax or something of that nature rather than income?

Governor CAREY. Yes. I wouldn't if I didn't think it was needed.

Representative BROWN. But the argument is whether the reduction in income taxes should be blocked, and I would say that your experience would argue against that. My time is up.

Representative REUSS. Thank you. Congresswoman Heckler.

IMPACT OF PROPOSITION 2½

Representative HECKLER. Thank you, Mr. Chairman.

Governor King, I think your charts have been very interesting. Obviously, the situation in Massachusetts is no longer as relevant as it once was—or at least much less relevant. However, there was some question about the impact of Proposition 2½. Massachusetts has had a double series of cutbacks, both Federal- and State-oriented. I personally was against Proposition 2½ because I was afraid it would be unfairly and unevenly administered. However, I question now, from experience, whether or not you feel there's been a negative impact on the elderly and the mentally retarded from the Proposition 2½ proposal.

Governor KING. I don't believe Proposition 2½ has in any way affected our human services programs. In my state of the State message, I remember two figures. In 1978, the last year before I started, and this year's budget, I believe it went from $340 to $630 million, something like an 87-percent increase. So we were able to do that; Proposition 2½ has produced a substantial tax relief for a lot of people and I think that's been very, very beneficial.

Representative HECKLER. Do you have any figures on the number of companies, or the amount of flight of industry from Massachusetts? We were suffering from the exodus into New Hampshire and other States prior to your administration. Do you have any current figures on that subject?

Governor KING. Well, just yesterday we were in one of the hearings of NGA where the Massachusetts Industrial Finance Agency came up and since 1979, 803 companies have participated in the bonding and I think 47,000 jobs were created, brand new companies, building that did not exist before. So we do not have any exodus whatsoever. We have a propeople climate, a probusiness climate if you will. We say that we invite all the business there. We tell them we are going to do everything to make you stay there profitably, recognizing if you didn't think so you wouldn't come here, and if profits don't come you're not going to stay here. So everything we have done in the propeople, probusiness climate is in the right direction, recognizing the fundamental strength of our Nation is in the free enterprise system, and the tax cuts, particularly the capital gains in income, are an incentive to people.

OCCUPATIONAL DEVELOPMENT

Representative HECKLER. Since we share with Governor Brown—fortunately for us—the high-technology industry which has produced a great number of jobs, would you say you're concerned about the continuation of that growth? The crisis of education indicates that we are not developing the level of math and science awareness in our students, at the high school and college level, that will keep that industry in our State perhaps even in the United States.

Governor KING. We were fortunate that right after the primary in 1978 the high-technology companies approached us and made me particularly aware, although generally I was, of their concerns, and as we started the transition with Judge Otis, who's now the secretary of economic affairs, who was an entrepreneur himself who started his own company and is now on the New York Stock Exchange, we laid out a program with the universities for the mathematicians, the scientists, and the engineers that would be needed. And while the high technology industry isn't totally satisfied, they really are amazed at the progress we have made.

Just recently one of the major companies, Mr. Wang's, donated 3 million dollars' worth of equipment to the universities. He's a member of the board of regents of our higher education department. The high technology industry as a whole has set aside 2 percent of their profits before taxes for education to be used for the training of instructors and professors, and/or for learning equipment or physical improvements to the educational institutions in order to meet industry's needs.

So we recognize the absolute fundamental that no company can be any better than its people and every company needs the expertise. For every 30 people employed, we need to have one key person employed, an engineer or a top professional, so it's incumbent upon us to produce them and to guarantee that they are present at both the public level and in private institutions. So we are in good shape.

Representative HECKLER. Governor, I'm concerned not only about the university level. I was very involved with making sure that tax credits for donations of equipment to universities were included in the recent tax bill. But I'm very concerned about the crisis in high school education, and the need for the donation of equipment there. I do intend to cosponsor the Stark bill, but I also feel that we must make the equipment available at the local level, to the local high schools.

Second, we must deal with the raiding of math and science teachers, especially math teachers, by industry—and somehow provide a substitute. We have an excess of teachers, but at the same time we are losing some of our finest math teachers to the same industry that is crying for, and asking us to have, higher academic standards. They are, on the one hand, saying the standards should be high—and I think rightfully so—and on the other hand, they are making it impossible for the local educational system to meet those standards, because they continue to hire the best math teachers available.

Governor KING. We are aware of that, too. The first move that we mentioned began with the community colleges and other colleges, but we have an education commission in the Commonwealth of Massachusetts and that has been working with vocational schools for maybe a couple of years now. I'm sure most equipment will go as needed to the specialty schools, the Wentworths or the vocational schools—and that would follow, but the basics are something that really have to be stressed. We are carefully watching the improvement, or lack of improvement, in the SAT's and the new commission gives us a chance to look back and review and decide. The fundamentals are the message of the day.

INDEXING

Representative HECKLER. I certainly appreciate what Mr. Wang has contributed. I think it's a lesson indeed to have the opportunity to see his generosity, and to see him set the pace of donations of equipment in such a significant fashion. It's quite indicative of the appreciation felt by those who come to our country from other lands. I think within our own country, we have an attitude that, certainly, we want to contribute—but in high technology industry, which is so vital in our State, we'll have to do more to meet the needs of the local school districts and the local students because if we're going to compete with Japan we must upgrade our educational standards.

I'd like to ask Governor Carey one question about the tax bill. Governor, I was quite surprised to hear you speak negatively about indexing, since that penalizes the low income wage earner so. The Joint Economic Committee in studying the Economic Recovery Act has found that by far the heaviest burden imposed by bracket creep was on the lowest wage earner. In fact, for the person earning between $5,000 and $10,000 a year, bracket creep—the amount that the Federal Government was invisibly stealing from the pocket of that particular worker—was 19.8 percent. The $30,000 wage earner was suffering a bracket creep of 8.6 percent. The higher the income rose, the smaller the bracket bite—because those individuals were already in high income brackets.

In view of that, and in view of the insidious nature of this invisible bracket creep tax, isn't indexing probably one of the best things we have done for the low income wage earner? At least now, won't those workers not be victimized by having this kind of a pickpocket operation?

Governor CAREY. Experience will show you that indexing can be very dangerous. It takes away your options to cope with the Federal needs and budget. You can't afford indexing. If you want to see how indexing is done, look at Minnesota. It drove business out of the State. Minnesota had a $700 million deficit because of indexing. You couldn't control the flow of revenues. Until you get the Federal budget under control, you can't afford indexing.

As I tried to say to Congressman Brown, we didn't just cut individual taxes in New York. We also targeted the savings and investment into opportunity zones to create jobs. The reason we were able to continue our tax reduction program to $6.3 billion is we took a philosophy and we made it a pragmatic practice. We increased the opportunity for jobs and then with the revenue base expanding from jobs, not from bracket creep, the number of additional people employed increased our revenue base so we could continue with targeted job opportunities—a loan program as was suggested here for small business, job incentive programs, job development loans. All of that mix of things is exactly what you should be doing at the Federal level.

But how can you do it when you're faced with a $147 billion deficit which can be reduced to $90 billion by cutting $50 billion? You've got to get your deficit under control.

Representative HECKLER. There are many, many facets to the question, of course. For the revenue receiver, indexing is a disaster because the silent tax no longer perpetuates itself, and the final pot of gold is far diminished. For the taxpayer, it seems to me, it's a fair break especially for the low income wage earner. Granted, the recipient Federal Government—Uncle Sam—is getting an extra bite in tax receipts. Without indexing, inflation pushed the wage earner into a new bracket and so Uncle Sam got richer. But is that a fair way to deal with the average American, one earning $25,000 down to $12,000, or the low income wage earner, who is paying the highest hidden tax—19.8 percent for the $5,000 to $10,000 wage earner? I don't know how that can be justified and it seems quite amazing to me that those who criticize the Economic Recovery Act as a tax break for the rich never understand or look at the tax break to those who are being unfairly victimized by a silent tax system that hits them disproportionately.

Governor CAREY. Let me suggest what will happen. When you're indexing you're constraining the Federal flow of funds to a level which will not sustain the support for poor people's programs and working poor programs. The Deputy Secretary of the Treasury has said this. We're cutting taxes. Now, if you people want to raise them you can do so. As Governor Lamm said, most State tax systems tend to be more regressive than the Federal system. Bracket creep normally affects higher level income people.

Representative HECKLER. Not really.

Governor CAREY. People who get higher wages through negotiated increases tend to be victims of bracket creep.

Representative HECKLER. That isn't the opinion of the Joint Economic Committee study.

Governor CAREY. Bracket creep affects people with more income.

Representative HECKLER. I disagree with that completely.

Governor CAREY. Let's take the person earning from $12,000 to $15,000, just above the poverty level in most States. What's going to happen to that person when the programs that most affect him—for his children's education, for support for local government functions and facilities in State government—are removed by the Federal Government? Do you know what's going to happen? You're going to have to do what States have been doing. More than half the States ran deficits, eliminated the surplus, had to raise local taxes. What benefit is it for you to index and hold your bracket creep down at the Federal level when the States who have income tax programs have to go ahead and increase income taxes and other taxes to make up the deficits in the Federal system?

Representative HECKLER. I think it's a question of integrity of the tax system. Is it correct, is it just, is it equitable to tax and to increase taxes invisibly on the lowest wage earners because ultimately they might, down the line, be recipients of some program? Isn't it far more equitable—since it's the responsibility of Government to be more direct about what it is funding, and the costs involved—to make the tax burden an equal one, not an invisible one that hits the lowest wage earner the hardest?

Governor CAREY. Yes. There are large corporations that pay almost no taxes.

Representative HECKLER. I agree with that, but I also think that you cannot oppose indexing. Inflation invisibly robs the lowest income wage earner, the one who's just making it, just getting into the marketplace, the one who has been the victim for all these years of a system that puts him or her into a position where their percentage of tax bite got disproportionately higher even though they might on another scale receive some Federal benefits. I doubt that all that equals out over a lifetime. The real victim of bracket creep is the less affluent, the low income person.

Governor LAMM. May I make a comment? Colorado was the first State to index. We're proud of it. It succeeded and the way you described it is correct, but you've got to come down on the side that the dislocations of the Federal indexing are immense and somebody should have very thoughtfully studied the full future implications over a number of years before all of a sudden getting a bill through Congress that was added to a tax package without even a hearing, as I understand it. Believe me, indexing which works in Colorado and which is fit into our long-term scheme, is a fiscal time bomb inserted in the Federal budget where its out-year implications are just immense.

Representative REUSS. Congressman Brown.

TAX CUTS; BALANCED BUDGET

Representative BROWN. Thank you, Mr. Chairman.

I just wanted to ask Governor King a couple of questions because I think they bear on the point. Many persons have argued that tax cuts reduced Government revenues to such an extent that budget cuts are required and budget cuts then cause human hardship. We heard the argument presented the other way, that first the Federal Government should balance the budget and then cut taxes.

What has happened to actual State and local revenues as taxes have been reduced in Massachusetts and why did you elect to go after—or did you elect to go after—your tax cuts first and then the reductions or the tightening up on welfare payments and so forth?

Governor KING. I believe that we approached both facets of that at the same time. We do not have the tremendous problem that our Nation has with the debt of over $1 trillion and the annual interest payments and the refunding problems. So we started with attrition of governmental employees right at January 1979 and it's significant at this time. We started on welfare.

Representative BROWN. On that basis, how do you feel about the welfare tradeoff, the AFDC and food stamp swap of the President?

Governor KING. I'm a supporter of federalism. I think something that is present, but I did not hear mentioned during the debate is that there's a tremendous saving to the bureaucracy both at the Federal and State level when you separate the State level from the Federal function and just let the one do it, tremendous savings which benefit both the States and the Federal Government. And, of course, when it does that it benefits our people.

Also, the purpose of the program is to provide a food stamp or a check or some sort of medical service. The service has to be poor when you only have one bureaucracy, whether it's Federal or State, rather than the intertwining. On the question of food stamps and the welfare, Governors preferred at this time to have it only as a matter of discussion. My understanding is that if it gets in the situation where it may be acceptable to the administration, the negotiating team will have to come back and bring it back to the Governors for approval, which would require a two-thirds vote because there's an existing policy now against the States assuming the costs of AFDC and food stamps.

Personally, unless the argument has merit—and I have not thought that through yet—if that has validity, I would just as soon go ahead with it right now. I'm doing that because the President has said twice that this is "dollar for dollar. We are not going to attempt to balance the Federal budget at the expense of the States. If you assume the responsibility for the program, we will give you the resources. There will be no winners and no losers." That's been said. That's part of the understanding on which I say that I will be a supporter of it.

Representative BROWN. Thank you, Mr. Chairman.

Representative REUSS. This concludes the Joint Economic Committee's annual inquiry into the state of the economy. Tomorrow at 2 o'clock in Rayburn 2128 we will make public our annual report. The President has asked Congress to put up or shut up and we have decided to put up, so that will be done tomorrow.

Meanwhile, Governors Brown, Carey, King, Lamm, and Matheson, many thanks to you. You have given us an awful lot to think about from your great testimony and we are grateful to you all. The committee stands adjourned.

[Whereupon, at 12:10 p.m., the committee adjourned, subject to the call of the Chair.]

APPENDIX

Statement of the American Council of Life Insurance

This statement is submitted on behalf of the American Council of Life Insurance, a national trade association with a membership of 524 companies which account for 96 percent of the legal reserve life insurance in force and 97 percent of the total assets of all U. S. life insurance companies. At the end of 1981, total assets of the life insurance business aggregated more than $520 billion, invested mainly in corporate and government securities and mortgage loans to business and individuals. These funds represent the savings that have been entrusted to the life insurance business by millions of individual policyholders and employee benefit plans. We are pleased to have this opportunity to present the views of our business to the Joint Economic Committee as part of its deliberations over national economic policies.

The Framework for Economic Policy

We believe that the major emphasis of national economic policy for 1982 should be to promote economic recovery while further reducing the rate of inflation. We are gratified by the progress that has been made over this past year in bringing down the inflation rate from the 12 to 13 percent range of late 1980 to a current level of about 8 percent. If appropriate economic policies are pursued, there is a definite prospect that inflation can be lowered still further by year-end to perhaps the 7 percent range.

Nevertheless, prospects for the economy in 1982 are far from favorable. The economy is currently in a cyclical recession which promises to boost the unemployment rate to 9 percent and beyond, while the plant utilization rate hovers just above 70 percent of capacity. Many forecasters both in government and in private industry are predicting that a trough will be reached within the next few months, but there is serious question about the strength of the recovery that is in prospect for the latter half of 1982.

A major reason for expecting a weak recovery is the drag on economic activity exerted by the current high levels of interest rates. In spite of the current economic downturn, long-term rates have recently moved back up toward the record highs that were reached last fall, which in turn exceeded the earlier peak levels registered at the end of 1980. In real terms, adjusted for the current inflation rate, long-term interest rates today have reached levels higher than at any time in this century, including even the years 1907, 1920 and 1931-32--years that are notable in economic history as periods of extreme financial stress. One goal of national economic policy must be to facilitate a reduction in real interest rates in order to foster economic recovery, but without triggering an upturn in the inflation rate.

Outlook for the Federal Budget

In our view, a major barrier to achieving the goals of sustainable economic growth, lower interest rates, and further reductions in inflation is the outlook for the federal budget. In his annual Budget Message, the President has projected a deficit of $99 billion in the current fiscal year, followed by a $92 billion budget deficit for the fiscal year 1983. Indeed, outside observers are fearful that the deficits in fiscal 1983 and beyond will register a succession of rising deficits, ranging well above $100 billion. This outcome could result from an unfortunate cycle in which incomplete economic recovery holds down tax revenues and enlarges the deficit, and the expanded need for borrowing then raises interest outlays on the debt, and leads to still larger deficits.

It is our considered opinion that the magnitude of the federal budget deficit now in prospect is intolerable. The Congress must find ways to achieve a substantial reduction in the fiscal year 1983 deficit and thereby break the potential cycle of escalating deficits in future years. This can be achieved, we believe, by a three-part program which scales down the proposed levels of military expenditures, cuts back on the high volume of outlays for federal transfer payments, and increases budget receipts by various methods to improve tax collections.

As to military spending, we note that the Budget Message proposes that defense outlays over the next few years would rise from 5.6 percent of the gross national product in 1981 to 7.3 percent in 1987. Taken as a share of the total federal budget, defense would climb from 24 percent last year to 37 percent in 1987. While we recognize the importance of maintaining a strong position for our national security, we question whether this sharp acceleration in military outlays is consistent with attainment of broader national goals. In our view, it would be shortsighted to subordinate the imperative of a healthy economy to the goal of strengthening our defense posture. We have learned in earlier periods of military activity that the most vital underpinning of a strong defense is a strong and productive economy. In order to further the goal of reducing the projected budget deficit by a significant amount, we urge the Congress to examine every possible avenue for achieving greater efficiencies in the application of our defense dollars.

The Role of Transfer Payments

Another area of federal outlays that requires close scrutiny is the area of transfer payments, comprising such functions as social security, medicare, federal retirement programs, veterans' benefits, welfare payments, and the like. We recognize that these many and varied programs have been developed over the years to meet very genuine needs in our society--the poor, the disadvantaged, and the elderly. But it has become increasingly clear that outlays for these programs threaten to expand beyond our capacity to support them.

Federal transfer payments to persons amounted to 4.6 percent of gross national product in the early 1960s, but this share had risen by 1981 to 9.6 percent of GNP. In order to hold back a continuation of this upward trend and also to achieve significant reduction in future deficits, we urge that federal transfer payments be held within the bounds of a simple guideline, namely, that such payments rise no faster than the growth in GNP in future budget years.

The third essential means for reducing the outsized budget deficit in 1983 is through federal tax policy that would increase the volume of tax collections. Methods should be chosen that would not disturb the basic thrust of the individual and corporate income tax reductions that were legislated last summer, to take effect in a series of steps. There are various ways that could be adopted to raise billions of dollars of additional revenue to the benefit of our national budget position, without jeopardizing incentives to work and invest. We urge the Congress to pursue these avenues in tax policy as one means of reducing the potential upward trend in budget deficits.

The Role of Monetary Policy

A critical element in achieving our national goals of renewed economic growth and greater price stability is the effective application of monetary policy. The Federal Reserve System has recently reaffirmed its 1982 policy targets, setting forth a range of 2½ percent to 5½ percent for the growth of the money supply (M1). This target represents a reduction in the upper limit of one half percentage point from the comparable monetary target for 1981 and is designed to achieve further progress in reducing price inflation.

As a broad rule, we believe that monetary policy should seek to assure that growth in the money supply will be sufficiently constrained to bring down the rate of inflation, while still leaving room for some real growth in economic activity. This is not an easy balancing act to achieve in practice, but it has become increasingly clear that the results desired for our economy cannot be achieved without persistent application of this approach over a considerable time period.

During the past three years, we have advocated a monetary policy of successively lower growth rates in the money supply. Indeed, we regard such a policy as a crucial element in the complex of national policies to bring about a lower rate of inflation. We therefore support the monetary targets announced recently by Federal Reserve Chairman Volcker. At the same time, it would seem appropriate for the Federal Reserve to tolerate M1 growth in 1982 near the upper end of its 2½ to 5½ percent target range, so as not to stifle emerging credit needs of the private sector as the economy moves into a recovery phase later in the year.

Summary

The current size of the federal deficit and the likely upward trend in deficits are intolerable. The potential harm to the economy from high "real" interest rates demands a reconsideration of the size of proposed increases in defense outlays as well as the scope and size of transfer payments. In addition, we must examine various possibilities for raising tax revenues as one necessary way to hold down the size of deficits. Without a strong economy we cannot hope to maintain a strong defense and meet the legitimate needs of other programs which government must provide.

Statement of Leonard M. Greene, President, the Institute for Socioeconomic Studies, White Plains, N.Y.

While the government has shifted from Keynesian to Supply-side theories of economics, the economy continues its roller-coaster ride from recovery to recession with persistent problems of inflation and declining productivity. It is time to focus on incentive economics.

The Reagan trickle-down theory will not be effective because it is coupled with a social welfare policy that aggravates work disincentives. The reductions in social spending have been targeted at the working poor -- the group least able to afford them. When the administration removes welfare eligibility for workers with earnings near the poverty level, it is taxing earnings excessively -- sometimes over 100 percent. The logical response is for workers to give up their jobs to regain welfare eligibility. They can then opt to supplement their benefits with unreported earnings in the underground economy. These choices lead to a reduction in productivity and the diversion of resources to less healthy sectors of the economy.

Reagan's attempt to direct benefits to the "truly needy" will in the long run have the perverse effect of increasing welfare expenditures as the number of "truly needy" increase. Historical evidence indicates that categorical aid programs induce people to adjust their status to match the recipient categories. While the working poor might be able to cope with the loss of AFDC benefits, the overlapping of programs seriously intensifies the problem. Medicaid in many cases is contingent upon AFDC eligibility and the benefits lost under this program may greatly exceed the workers total earnings. Why should a welfare mother work when her net return after inclusion of benefits is small or possibly negative?

In addition to reaffirming categorical aid, the Reagan administration has increased bureaucratic burdens. States have found the $1,000 asset limit for AFDC recipients burdensome to enforce and many have chosen not to do so. While the administration has relaxed and simplified regulations in many sectors of the economy, it has done the reverse in regard to welfare programs.

We can not restore the economy to good health without improving productivity. This will not be accomplished as long as marginal workers are induced by public policy to live off the dole instead of working. The welfare rolls will decline and the work force increase when incentives are provided to make this profitable.

In a recent book Free Enterprise Without Poverty, I outlined a plan that would accomplish such a result. We must provide a basic level of support for the needy with low marginal tax rates so that the individual is always better off if he works. The current myopic policy of reducing welfare expenditures by targeting aid to the "truly needy" must in the long-term have contrary results.

The Reagan administration was correct in its intention of improving productivity by enhancing incentives for business and reducing regulations. Why then in the most troublesome area of the economy -- social welfare expenditures -- has it opted to do the reverse? An extrapolation of the administration's general policies would be expected to strengthen the incentives to work even if this meant that in the short run all benefits were no longer to be limited to the "truly needy." An administration so sensitive to the benefits of tax cuts for the wealthy should understand the devastating impact of tax increases on the poor.

At present the one bright light in the economic picture is the abatement of inflation. I believe that the stimulus necessary to bring us out of the current recession will undo the progress on inflation we have witnessed so far. Ultimately only increased productivity will solve the inflation problem and this will not occur until we create a climate that provides a strong incentive to work.

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