1381

99th Congress
2d Session

JOINT COMMITTEE PRINT

S. PRT.
99-172

THE POLITICS OF TRIUMPH

A 1986 MIDYEAR REVIEW OF THE U.S. ECONOMY

PREPARED FOR THE USE OF THE

JOINT ECONOMIC COMMITTEE CONGRESS OF THE UNITED STATES

BY THE

REPUBLICAN MEMBERS

OF THE

JOINT ECONOMIC COMMITTEE

together with

DISSENTING VIEWS

AUGUST 6, 1986

Printed for the use of the Joint Economic Committee

U.S. GOVERNMENT PRINTING OFFICE
62-113 O WASHINGTON : 1986

For sale by the Superintendent of Documents, Congressional Sales Office
U.S. Government Printing Office, Washington, DC 20402

JOINT ECONOMIC COMMITTEE

[Created pursuant to sec. 5(a) of Public Law 304, 79th Congress]

HOUSE OF REPRESENTATIVES

DAVID R. OBEY, Wisconsin, *Chairman*
LEE H. HAMILTON, Indiana
PARREN J. MITCHELL, Maryland
AUGUSTUS F. HAWKINS, California
JAMES H. SCHEUER, New York
FORTNEY H. (PETE) STARK, California
CHALMERS P. WYLIE, Ohio
DANIEL E. LUNGREN, California
OLYMPIA J. SNOWE, Maine
BOBBI FIEDLER, California

SENATE

JAMES ABDNOR, South Dakota, *Vice Chairman*
WILLIAM V. ROTH, JR., Delaware
STEVEN D. SYMMS, Idaho
MACK MATTINGLY, Georgia
ALFONSE M. D'AMATO, New York
PETE WILSON, California
LLOYD BENTSEN, Texas
WILLIAM PROXMIRE, Wisconsin
EDWARD M. KENNEDY, Massachusetts
PAUL S. SARBANES, Maryland

SCOTT LILLY, *Executive Director*
ROBERT J. TOSTERUD, *Deputy Director*

LETTER OF TRANSMITTAL

JULY 31, 1986.

Hon. DAVID R. OBEY,
Chairman, Joint Economic Committee,
Congress of the United States, Washington, DC.

DEAR MR. CHAIRMAN: I am pleased to submit a 1986 midyear review of the U.S. economy entitled "The Politics of Triumph." This report was prepared by the Republican members of the Joint Economic Committee for the use of the Committee and the Congress.

At the present time, most economic indicators suggest continuing growth well into 1987. These signals are just part of our reasons for optimism, however. Other factors point to a sustained period of expansion. Two major political events are setting the stage for long-term economic growth: meaningful tax reform and reduction of the budget deficit. The agricultural and rural economies continue to concern us, however.

Tax reform holds the promise not only for fairness but also for a return to economic principles in decisionmaking. Under current law, too often our choices regarding consumption, saving, and investment are dictated more by tax considerations than by sound financial judgment, for individuals and business alike. Deficit reduction in the steady, orderly manner of Gramm-Rudman-Hollings will contribute to fiscal stability and will stimulate growth by leaving a greater portion of economic activity in the private sector.

Another significant, yet intangible, force underlies our positive outlook for the U.S. economy. Presidential leadership has invigorated governmental and economic institutions—not by altering them, but by changing the attitude of Americans. Leadership, combined with a commitment to American values, produced a revolution—a politics of triumph.

Sincerely,

JAMES ABDNOR,
Vice Chairman, Joint Economic Committee.

CONTENTS

I. THE POLITICS OF TRIUMPH

> What do we mean by the Revolution? The War? That was not part of the Revolution; it was only an effect and consequence of it. The Revolution was in the minds of the people. * * *
>
> —In a letter from John Adams to Thomas Jefferson in 1815

> History has recorded personal accounts of Union soldiers refusing to pull the trigger when they found in their gunsights the universally revered Confederate General Thomas Jonathan "Stonewall" Jackson. Proven effective and respected leadership is appreciated and admired by friend and foe alike.

"Revolution" can be defined basically in two ways. One concerns the radical change or overthrow of a government or its institutions, the other a movement in a circle, or a turning around. Ronald Reagan's revolution was the turning around of the electorate's political and philosophical mind. This pivotal shift in the public mind is the democratic means by which fundamental and lasting change is achieved within government and its institutions. Persuading a majority of Representatives and Senators to agree to a budget calling for a cut in Federal spending is no easy task, but by no means is it a revolution. As John Adams said, the revolution is in the minds of the people.

While we Americans pride ourselves on our political system and capitalist economy—democracy and free enterprise—there is no denying the influence of politics in our economic affairs. Every economic system is a political economy. Politics affects the economy not only through congressional and bureaucratic policymaking, but also through presidential leadership.

In 1980 and again in 1984 Ronald Reagan received a mandate for leadership. Unlike so many of his recent predecessors, President Reagan knows what leadership is and unhesitatingly accepted its responsibilities. This commitment to lead, combined with his commitment to traditional American values, has produced a national environment of confidence: a revolution—a turning—in the public mind, and ultimately, the politics of triumph.

The politics of triumph is a strategy of policymaking. President Reagan's triumph within—not over—the minds of Americans has given him the broad-based political strength to successfully pursue economic, social, and foreign policy initiatives previously thought to be unattainable.

Effective leadership spawns confidence. That virtue of trust, assurance, and reliance not only enables government to work with purpose and effectiveness, but also imparts strength in the economy. Confidence builds enthusiasm and courage that energizes free enterprise, creates ambition, and fosters innovation. Confidence has no substitute as an inspiration to a people and a drive to an economy. That President Reagan is inspiring the needed confidence is shown by a recent Gallup Poll that found that the President has a 68 percent job approval rating and "is riding a crest of public support unprecedented in Gallup Poll annals." The leadership quality of President Reagan is an inestimable contributor to the robust and dynamic U.S. economy.

The Reagan Administration sought in 1981 to change the way the Federal Government conducts public affairs, and consequently, to remedy the way individuals and free markets are inhibited by government action. A bold four-point plan was launched to reduce the size of the Federal Government and its involvement in the private sector, to reduce regulatory burdens rendered obsolete or ineffective by technical and social changes, to stabilize monetary policy to halt inflation, and to lower tax rates and the tax burden. To implement such a plan required forceful application of a politics of triumph.

Today, few suggest that Washington policymakers are conducting business as usual and that 1980 attitudes toward government and the private sector are the status quo in 1986, in either political party. The desirability of self-reliance, accountability, individual initiative, investment, productivity, profitability, and patriotism have gained acceptance and received a renewed emphasis. Consistent with this rejuvenation is America's recognition that the Federal Government is seldom the most successful motivator, the fairest distributor, or even a good economic planner for the American people.

Considerable progress has been accomplished on a number of economic fronts, enhancing the chances for a generation of continued economic growth. Deficit reduction, tax reform without tax increases, and consistent monetary policy offer the market the promise of long-term stability and sustained growth.

The current economic expansion is in its 45th month, making it the second longest peacetime expansion in U.S. history. The United States is poised to reap even more benefits from its economic strengths. Low inflation guarantees consumers that their purchasing power will not be stolen. It offers industry a far less volatile business environment than it faced in the 1970s. Lower interest rates point to business opportunity and to lower cost consumer loans and mortgages. Internationally, the value of the dollar has significantly adjusted toward equilibrium in the past year, offering prospects for greater exports in the months ahead. Money supply growth in recent months provides the financial footing for continued expansion of the economy.

These encouraging trends are leading economic indicators that support an optimistic outlook for the remainder of this year and beyond. However, not all indicators are favorable. The trade deficit will not be eliminated solely by a lower value of the dollar. For example, imports continue to increase because import prices do not fully reflect changes in exchange rates, particularly in the case of Japan. Barriers to free trade are interfering with the ability of the United States to regain its market shares. Third World countries continue to struggle with debt loads and therefore are not in a position to contribute to an expanding global economy. The agricultural, natural resource, and rural economies, while improved from their setbacks in the late 1970s, still lag behind the economic performance of metropolitan areas. But we have learned that these problems will be addressed with confidence, not with malaisic despair.

The resilience of the American economy is derived from strong economic fundamentals and from presidential leadership that have rekindled America's vitality and relied on sound economic principles, incentives for initiative, and rewards for achievement.

II. A REVIEW OF ECONOMIC POLICY: FROM MALAISE TO CONFIDENCE

The economic policy during the past five and a half years of Republican leadership has restored our economy's foundation for future economic growth. There are two success stories here:

- The reduction of high inflation rates and high interest rates and
- Restructuring the economy for greater future growth.

When President Reagan was inaugurated in 1981, not only were the economic indicators flashing red danger signals, the economy was moving toward even more serious problems. Inflation was high and growing. Some feared an inflationary spiral reminiscent of postwar Europe. Interest rates were high, both in absolute terms and after adjusting for expected inflation. Investment was slowing, bringing worries about worse economic performance in the mid-1980s, as low investment would cause productivity to decline. In short, we were moving into a recession. In fact, the case can be made that 1980–82 was one continuous recession.

There was no immediate improvement in the economy when President Reagan took office, nor could one have reasonably been expected. Had there been policies available that could instantly change a weak, inflation-ridden economy into a growth economy with low inflation, then there is little doubt that President Carter would have enacted them, since noninflationary growth was enunciated many times as one of his economic objectives.

There *were*, however, policies available that could have brought better long-term growth—the supply-side policies that were recommended in the bipartisan Joint Economic Committee Annual Report of 1980, entitled *Plugging in the Supply Side*. In this report, Republican Congressman Clarence Brown said:

The proper policy "mix," as outlined in this report, is:

1. To fight inflation by a gradual (but sustained) reduction in the growth of the money supply and a gradual reduction of the ratio of Federal direct and regulatory spending to GNP.
2. To fight general unemployment by increasing real economic growth through tax reductions designed, not to pump money into the economy, but to restructure the tax code to increase the after-tax reward to additional saving, investment, production, and employment. The tax structure must direct more of our annual economic effort into modernization for competitiveness and growth rather than immediate consumption.
3. To fight hardcore unemployment by a targeted program emphasizing productive, private sector, on-the-job training to increase the skills of the unemployed. Structural unemployment is not a problem which can or should be solved by pump-

ing money into "make-work" jobs to inflate the whole economy.

The Democratic Chairman of the JEC, Senator Lloyd Bentsen, made similar points in his introduction:

> * * * (S)teady economic growth, created by productivity gains and accompanied by a stable fiscal policy and a gradual reduction in the growth of the money supply over a period of years, can reduce inflation significantly during the 1980s without increasing unemployment. To achieve this goal, the Committee recommends a comprehensive set of policies designed to enhance the productive side, the supply side of the economy. The Committee also recommends a * * * deemphasis of marco-economic fine-tuning.

The JEC report also called for a "* * * gradually reduced share of Federal outlays in the gross national product."

But President Carter was mired in the malaise of the "zero-sum economy," which he hoped to manipulate by a mixture of controls and demand-side stimulation. The Council of Economic Advisers' report of 1981 called for a "voluntary incomes policy" and discussed something called "TIP," which was a proposal to discourage inflation by imposing heavy tax penalties on anyone who raised prices. The report also called for a delay in proposed tax reductions and a 10 cents per gallon tax on gasoline. One of the last major policy actions of the Carter Administration was the wrenching credit controls of 1980, which were rescinded after they had accomplished little more than the disruption of financial markets.

The new Republican Administration's basic strategy for economic recovery consisted of three parts:

> Reductions in marginal tax rates on individuals that would stimulate investment and economic activity. It is important to recognize that the essence of supply-side tax cutting is the reduction in *rates,* rather than a belief that lower tax payments will stimulate the economy in a Keynesian pump-priming exercise. Tax reductions to stimulate business investment were also part of the plan.
>
> Reductions in Federal spending. Here the idea is that the sheer gigantic size of the Federal Government's intervention into the economy, measured by the ratio of outlays to gross national product, crowds out private economic activities. It is just as important to reduce the government's massive interventions into credit markets, with loans and guarantees of steadily increasing magnitude. The Reagan Administration, however, was not fully able to carry out its original plans to reduce Federal spending; outlays as a percentage of GNP were 22.1 percent in FY 1980, 23.7 percent in FY 1982, and still will be about 23.4 percent in FY 1986.
>
> Reduced growth in the money supply. Excessive monetary growth is the cause of inflation, and it is clear that rapid growth in the stock of money and a loss of confidence in the dollar were the major forces behind the inflationary trend of the late 1970s. The need for slower growth in the money supply had already been recognized. But relatively few people understood that monetary restriction would have to be contin-

ued for some time or it would have no lasting effect. Several times before, the Fed had started the process of monetary tightening, only to surrender to various worries long before the battle for stable prices was won.

But this time monetary policy worked, because it was given time and presidential support to work. For once, the Administration and the Federal Reserve had the patience and the courage to see the struggle through.

Some have criticized the Fed for tightening money too sharply and for allowing gyrations in the money supply. There is merit in these criticisms, but they are secondary to the main success story of reducing inflation and expectations of future inflation. It is not clear whether or how the critics could have improved upon the Reagan Administration's results.

To repeat, these three parts of the economic strategy were not carried out flawlessly. Tax cuts were delayed; spending reductions were incomplete; and monetary policy was somewhat erratic. Perhaps this lack of precision is the nature of economic policy in a democracy. But taken together these policies accomplished what others had failed to do for several administrations. They brought back price stability and they put the economy on a sustainable growth path.

The Success of Supply-Side Tax Policy

When the supply-side policy emerged in the late 1970s, tax reduction was one element of a larger program that included restraint in the growth of Federal spending, gradual deceleration of monetary growth rates and inflation, and deregulation. Each element of the program rested on the conviction that Federal involvement in the economy had reached levels high enough to seriously undermine economic growth. The ultimate purpose of the program was to restore noninflationary economic growth in order to improve the American standard of living, which had eroded in the 1970s. The broad support enjoyed by the supply-side program was evidenced in its bipartisan and unanimous endorsement in the 1979 and 1980 annual reports of the Joint Economic Committee.

The legislative expression of supply-side tax policy was the Roth-Kemp bill, which called for a 30 percent across-the-board reduction in personal marginal tax rates over three years. The high rates along with inflation had undercut incentives to work, save, and invest, thus hindering economic growth. A large tax wedge had been driven between the value of such activities to society and their return to factor owners, with the result that some resources were withheld from productive use. Lower marginal tax rates would reduce the "tax wedge," thereby making it worthwhile to put more resources to work and creating a supply-side boost to output.

The counterproductive height of marginal tax rates prevailing in the late 1970s resulted principally from inflation-induced bracket creep, though the top marginal rate of 70 percent was also excessive. To an extent still unrealized today, the bracket creep of the 1960s and 1970s radically transformed the tax system by shoving a growing proportion of taxpayers into brackets originally reserved for the well-to-do.

As the table below shows, marginal tax rates for families with incomes near the median as well as others increased sharply soon after the Kennedy tax cuts, even though no legislative changes in tax rates were made until 1981. Between 1965 and 1980 the marginal tax rates applied to median family income jumped from 17 to 24 percent, an increase of 41 percent.

TABLE II.1.—MARGINAL PERSONAL INCOME TAX RATES FOR 4-PERSON FAMILIES

[Selected years, 1965–80]

Year	Family income (percent)		
	One-half median income	Median income	Twice median income
1965	14	17	22
1970	15	20	26
1975	17	22	32
1980	18	24	43

Source: Economic Report of the President, 1982.

Another confirmation of the bracket-creep phenomenon is evident from the weighted average of marginal tax rates, which had risen from 21.8 percent in 1965 to 31.4 percent in 1980. This amounts to an unlegislated tax-rate increase of 44 percent. It was estimated that without corrective action the weighted average of marginal tax rates would have exceeded 40 percent by 1985.

The dramatic rise in tax rates radically changed the structure of the tax system. As Professors James Gwartney and Richard Stroup have pointed out, up until the mid-1960s the rate structure was virtually flat for all but the top 5 percent of income recipients. In 1962 taxpayers falling between the 20th percentile (the personal exemption excluded filers below this level) and 89th percentile faced a marginal tax rate between 20 and 22 percent; the highest rate paid up to the 96th percentile was 26 percent. Only the top 4 percent of income recipients confronted marginal tax rates ranging up to 91 percent. The point is that the rate schedule that applied to almost all taxpayers was extremely flat; the taxpayers at the 20th and 75th percentiles paid about the same 20–22 percent marginal rate.

By 1980 the picture was entirely different. Progressively higher marginal tax rates applied to a broad range of income. By 1980 taxpayers in the 75th percentile were paying twice the marginal tax rates as those in the 20th percentile. The economic problem was that a fairly large group of taxpayers had been pushed into tax brackets high enough to discourage work, saving, and investment, and to encourage use of tax shelters and other forms of avoidance.

Not only did the tax system become more progressive, tax rates became generally higher. In 1965 only 2.7 percent of taxpayers faced marginal tax rates in excess of 28 percent. By 1975 this proportion had climbed to 12 percent and 26 percent by 1980—about 10 times its level in 1965. This in turn induced a change in taxpayer behavior that was very counterproductive. The broad consensus that high tax rates were harmful to the economy led to efforts by both parties to lessen the tax burden.

THE ECONOMIC RECOVERY TAX ACT OF 1981 (ERTA)

Early versions of ERTA combined the across-the-board rate cuts of Roth-Kemp with an Accelerated Cost Recovery System (ACRS). ACRS and certain other provisions were designed to replace the inadequate and cumbersome depreciation system then current in law. In the final stages of compromise, the 10–10–10 schedule of individual rate cuts was reduced to a 5–10–10 schedule. Furthermore, the effective date of this provision was delayed from January 1, 1981 to the fourth quarter of 1981, in which the first installment was to take the form of a tax credit.

This delay proved to be especially unfortunate given the abrupt change in monetary policy initiated in April 1981. In the subsequent six months the Federal Reserve brought money growth from the double-digit range to zero, a change which the Administration had announced that it wished to achieve gradually over four years. The resulting recession, which began in July 1981, could not be prevented or ameliorated by means of tax cuts, because they had been delayed. Consequently, much of the economic stimulus resulting from the tax cuts had to await their full implementation in 1983.

Once the recovery started, business investment expanded at a very rapid pace. Real gross private domestic investment increased 12.5 percent in 1983 and 31.4 percent in 1984. As a result, its share of GNP reached a postwar high in 1984. The contribution of investment to GNP growth during this time also illustrates the expansion's supply-side origin.

Over the first six quarters of the current expansion, gross private domestic investment contributed 38 percent of real GNP growth, compared with 15.7 percent in the average postwar recovery. In the first three years of this expansion the investment contribution to GNP amounted to 17.4 percent, compared with the postwar average of 10.6 percent. Furthermore, according to a study by Michael Boskin, as much as 20 percent of the investment boom can be attributed to the tax incentives in ERTA, as modified by the Tax Equity and Fiscal Responsibility Tax Act (TEFRA). The high rate of investment and its large contribution to economic growth substantiates the view that this is a supply-side recovery.

The current economic expansion has created over 10 million new payroll jobs, broken the upward trend in the poverty rate that began in the late 1970s, increased real family income, and raised American living standards. Thus the tax program did achieve its intended goal of economic revitalization.

Unfortunately, personal and corporate marginal tax rates still remain high enough to impede economic efficiency and growth. The success of the Reagan program laid the foundation for subsequent efforts to further slash marginal tax rates. The current effort would lower personal tax rates 61 percent below their 1981 levels, a prospect unthinkable before the Reagan revolution. This radical reduction in tax rates will certainly be one of the most enduring domestic legacies of the Reagan Administration.

SENATE FINANCE COMMITTEE TAX REFORM BILL

The Senate's Tax Reform Act of 1986 would compress the 14 brackets of the current tax rate schedule into a two-step schedule with rates of 15 and 27 percent. Owing to other provisions, the effective marginal tax rate could be as high as 32 percent for some taxpayers over a range of income between $75,000 and $145,000 (joint returns). The new tax rate schedule would become effective on July 1, 1987. Most of the base broadening provisions would take effect six months earlier, on January 1, 1987.

A standard deduction of $5,000 for couples filing jointly, and $3,000 for single persons, would replace the corresponding $3,670 and $2,480 zero bracket amounts of current law. Extra $600 standard deductions for the blind and elderly would also be provided. The personal exemption would be increased from $1,080 to $2,000 for itemizers and non-itemizers.

The inflation indexing of tax brackets would remain. Deductions for mortgage interest, state and local income taxes, real estate taxes, and personal property taxes would be retained. Itemizers could also still use deductions for charitable contributions, casualty losses, medical expenses (if over 10 percent of adjusted gross income (AGI)), and adoption of certain handicapped children. Health, group life, and legal insurance would continue to be excluded from taxable income.

Deductions for contributions for Individual Retirement Accounts (IRAs) could be made only by those not covered by another pension plan. The ceiling on tax deferred contributions to 401(K) plans would be reduced from $30,000 to $7,000. The two-earner deduction would be repealed. Unemployment compensation would be fully subject to taxation; workers compensation would not be taxed. The $100/$200 dividend exclusion would be repealed, as well as the deductibility of most interest expenses by consumers.

The capital gains exclusion would be repealed, with gains being treated as ordinary income. This would effectively raise the maximum capital gains tax rate from 20 to 27 percent. Capital loss deductions would be limited.

The maximum corporate tax rate would be reduced from 46 to 33 percent. A graduated schedule with lower rates would be provided for small corporations. The corporate capital gains tax rate would remain at 28 percent.

The investment tax credit would be repealed, effective on January 1, 1986.

The current ACRS depreciation system would be liberalized partly to compensate for the loss of the ITC. Recovery periods for most real estate investments would be lengthened. Small businesses could expense the first $10,000 of tangible personal property. The 25 percent tax credit for incremental research and development spending would be extended for four years (1986 to 1989); it expired at the end of 1985.

The Senate Finance Committee bill is the best tax legislation since the Revenue Act of 1926, which lowered the top personal rate from 46 percent to 25 percent. The 1986 reform will increase reliance on market forces instead of tax considerations in the making of business decisions and improve economic efficiency.

TAXING THE RICH

The 1981 tax reduction, by sharply reducing the top personal tax rate to 50 percent, undermined the notion that fairness requires steeply progressive tax rates. New Internal Revenue Service *Statistics on Income* (SOI) data show why the supposed connection between progressivity and "fairness" has lost much, if not all, of its strength in the 1980s. Consequently, this once-fertile ground for demagoguery has become increasingly irrelevant in setting tax policy.

In 1981 the Reagan tax cuts were fiercely opposed by the Democratic left as "giveaway to the rich" that would make the tax system less progressive. The tax burden would allegedly be shifted from the rich onto the backs of mid-income and low-income Americans. The flaw in this argument was that it ignored the purely symbolic nature of high, apparently progressive, statutory tax rates. They simply were not being paid by many wealthy people. Though high tax rates made soakers-of-the-rich feel good about the tax system, in fact they were not progressive in their impact.

The reason is that high rates discourage taxable economic activity, inducing the rich and not-so-rich into tax shelters, and encouraging other means of tax avoidance. Hence, high tax rates can reduce the tax base, potentially enough to lower tax revenues. While the primary objective of ERTA in 1981 was to lower tax barriers to economic growth, a secondary result has been an increased progressivity in the distribution of the tax burden.

Despite the 1981 predictions of opponents, and the skepticism of just about everyone else, the tax burden has shifted in the way supply-siders said it would. The changes in tax liability are especially striking at the upper income levels. For example, the group of taxpayers with $1,000,000 or more adjusted gross income paid 210 percent more in taxes in 1984 than in 1981. Those with adjusted gross incomes between $500,000 and $1,000,000 paid 97 percent more over the same period. Tax revenues contributed by the group with $100,000 to $500,000 AGI rose 31 percent, while revenues from the group earning between $50,000 and $100,000 AGI climbed 30 percent. Meanwhile, tax payments by those earning between $25,000 and $50,000 AGI declined 3.3 percent between 1981 and 1984.

Though these figures clearly indicate that tax payments by the super wealthy have dramatically increased since 1981, they are somewhat distorted by inflation-induced bracket creep (there was no indexing until 1985) and do not permit firm conclusions about distribution of the tax burden. A better organization of data for this purpose is based on a percentile grouping of taxpayers. Data based on the top 1 and 5 percent and bottom 50 percent of all taxpayers (Table II.2) is illustrative.

Revenues derived from the top 1 percent steadily increased after 1981, even though the top marginal tax rate was cut from 70 to 50 percent on January 1, 1982. Despite the severity of the recession, income tax revenues paid by the top 1 percent climbed from $51 billion in 1981 to $53.6 billion in 1982. After a more modest increase in 1983, revenues from this source surged 18 percent in 1984 to $63.8 billion. Over the 1981 to 1984 period revenues derived from this source climbed by 25 percent.

Income tax revenues drawn from the top 5 percent grew from $98.6 billion to $117.3 billion between 1981 and 1984, an increase of 19 percent. Revenues from the top 10 percent grew from $136 billion in 1981 to $152 billion in 1984, a rise of 12 percent. These figures demonstrate that revenue growth was progressively more rapid the higher the income percentile.

Meanwhile, the lowest 95 percent of the income distribution contributed $183.6 billion in 1981 and $182 billion in 1984, a decline of about 1 percent. Revenues derived from the bottom 75 percent of taxpayers were practically unchanged in 1984 relative to 1981. The bottom 50 percent contributed less Federal revenue in 1982 and 1983 than in 1981. In 1984 revenues from this source rose to a level 4 percent above 1981, owing to bracket creep and strong economic growth.

THE CHANGING TAX BURDEN

Since tax payments by the wealthy clearly increased strongly between 1981 and 1984, while taxes paid by everyone else remained constant or increased only slightly, one would expect that more of the tax burden was shifted onto upper income taxpayers. The *Statistics of Income,* published by the Internal Revenue Service, show that this indeed is what happened. Table II.2 displays the tax burden of the various percentile taxpayer groupings between 1981 and 1984.

TABLE II.2—SHARE OF THE TAX BURDEN

Year	Highest 1 percent	Highest 5 percent	Lowest 50 percent
1981	18.0	34.0	7.4
1982	19.4	36.0	7.3
1983	19.9	37.2	7.2
1984	21.3	39.2	7.3

Source: Internal Revenue Service, Statistics of Income.

As can be seen in Table II.2, the share of total income tax collections borne by the top 1 percentile increased sharply after the top rate was slashed in 1982. In 1981 the rich paid 18.0 percent of all personal income taxes; just one year later they paid 19.4 percent of the total. Despite the arguments of the time that this was a one-time fluke, the wealthy's share increased by half a percentage point in 1983 to a level of 19.9 percent. In 1984 the share paid by the rich jumped again to 21.3 percent, another large increase.

In sum, the tax burden of the very rich increased 7.8 percent in 1982, 2.6 percent in 1983, and 7 percent in 1984. Between 1981 and 1984, the total percentage change in the tax burden of the rich amounted to 18.3 percent, a significant increase by any measure. This same trend is duplicated by the top 5 percent of the income earners.

In 1981 the top 5 percent of all taxpayers paid 34.9 percent of all income taxes. A year later the share of this group jumped a full percentage point, to 36.0 percent. The 1983 rise pushed the share to

37.2 percent. By 1984 it had climbed to 39.2 percent. In other words, over four tax years the share paid by the top 5 percent of all taxpayers, including the rich and well-to-do, had shot up over four percentage points. This translates into an increase of 12 percent over the four years considered here.

Meanwhile, the tax burden of the bottom three quarters of taxpayers declined each year after 1981. By 1984 their share of the tax burden had declined to 26.2 percent from 27.8 percent in 1981. This amounts to a 6 percent decline over these four years. The relatively small share of taxes paid by the bottom 50 percent declined slightly, from 7.5 to 7.3 percent.

The experience of the last five years shows that cutting tax rates can elicit increased revenues from those who face high, incentive-deadening marginal tax rates. The effect of lowering excessively high tax rates is to increase, not decrease, the actual progressivity of the tax system. To the extent that distribution of the tax burden should be the measure of fairness considered in tax policy, the 1981 tax legislation made the tax system fairer because the rich have paid more of the personal income tax. The 1981 to 1984 data also suggest that the Senate Finance Committee's bill expected 4.7 percent decline in revenues paid by those incomes above $200,000 is probably overstated. Taxes paid by this group could well increase if that bill were enacted.

THE FEDERAL BUDGET

As mentioned earlier, restraining Federal spending growth was a major element of the Administration's program. The large and growing amount of resources absorbed by the Federal Government deprives the private sector of needed funds for saving, investment, and consumption. Moreover, it deprives people of choices of how to spend their money. Furthermore, the cost of Federal spending significantly exceeds the dollar amount of funds taken from the private sector through taxation and borrowing, because both activities impose costly inefficiencies. By the late 1970s, the level of Federal resource absorption exceeded 22 percent of GNP, with many Federal progams providing benefits that failed to cover their direct and indirect costs.

BUDGET TRENDS

Ever since the initiation of the Great Society programs in the mid-1960s, Federal spending has exploded. Federal outlays jumped from $118 billion in 1965 to $946 billion in 1985, an increase of 700 percent. Measured in constant dollars, this amounts to a rise of 214 percent. Table II.3 shows the budget totals as a share of GNP since 1965.

TABLE II.3.—OUTLAYS, RECEIPTS, AND DEFICITS, 1965–85

[Dollar amounts in billions]

Year	Outlays		Receipts		Deficits	
	Amount	Percent of GNP	Amount	Percent of GNP	Amount	Percent of GNP
1965	$118.2	17.6	$116.8	17.3	$1.4	−0.2
1970	195.6	19.8	192.8	19.5	−2.8	−.3
1975	332.3	21.8	279.1	18.3	−53.2	−3.5
1980	590.9	22.2	517.1	19.4	−73.8	−2.8
1981	678.7	22.7	599.3	20.1	−78.9	−2.6
1982	745.7	23.7	617.8	19.7	−127.9	−4.1
1983	808.3	24.3	600.6	18.1	−207.8	−6.3
1984	851.8	23.1	666.5	18.0	−185.3	−5.0
1985	946.3	24.0	734.1	18.6	−212.2	−5.4
1986[1]	980.0	22.9	777.1	18.2	−202.8	−4.7

[1] Estimates from 1987 Budget of the United States.

Source: Office of Management and Budget.

The rapid growth of Federal outlays was fueled by an enormous surge in transfer program spending. Between 1965 and 1985 transfer payments leapt from $33 billion to $425.6 billion, a jump of 1190 percent. This translates into a real increase of 409 percent. As a share of GNP, transfer payments climbed from 4.9 percent in 1965 to 10.8 percent in 1985.

As Table II.3 shows, the Administration has had only mixed success in getting control of the budget. Unfortunately, Federal spending is still rising at a fairly rapid pace. On the other hand, the Administration has been somewhat successful in containing the expansion of transfer payments as a share of GNP. After peaking in fiscal 1983 at 11.9 percent of GNP, the transfer-payment share fell to 10.8 percent in both fiscal 1984 and 1985.

The Administration's only check on the budget is the President's veto authority, and even that can be overridden by the Congress. Article I of the Constitution explicitly charges Congress with the primary responsibility for setting taxing and spending decisions. Unfortunately, there are very powerful forces under the current institutional arrangement in Congress which militate against fiscal discipline and spending control. Fundamentally, a politician's true worth is better measured by what he *doesn't* spend than by what he does spend.

THE NECESSITY OF BUDGET REFORM

The Administration's strategy was to restrain Federal spending growth while promoting economic expansion, thus shrinking the relative size of Federal outlays. The 1981 Reconciliation Act, popularly known as Gramm-Latta, was a good start in the direction of budget control. However, the Administration recognized that there is a defect in our political institutions that encourages excessive spending. Hence its call for institutional reforms such as a balanced-budget/tax-limitation constitutional amendment.

Under current arrangements the benefits of any constituent spending program are presented to members of the legislature in the most forceful terms, while the costs of a program are diffused among all taxpayers, and hence are less visible. This fiscal illusion produces irrational results because virtually all constituent groups that receive special program funding also shoulder the tax burden. If Federal spending is spread evenly, then a reshuffling of dollars is taking place with no one better off than if none of the programs were approved. If some programs receive more support than others, then some groups are taxed relatively more heavily to support the benefits of others, a result which follows from the greater political power of the net beneficiaries. In either case, the funding of such programs imposes more costs than benefits on society as a whole. Because of efficiency losses resulting from taxation, each dollar of Federal expenditure must provide substantially more than a dollar of benefits if net social welfare is to be improved.

Consider the analogy of 10 people going out to dinner together under two alternative arrangements. In the first case, the diners assume that the total bill will be evenly split regardless of the cost of each meal. In the second case, an agreement is made before dinner that each diner will pay only for his own meal. Human nature being what it is, the total dinner check in the first instance will be larger than in the second.

If, under the first arrangement, one person attempts to be frugal while the others do not, he will receive only one-tenth of the savings generated by his frugality. The other diners will enjoy the same savings, while also enjoying a better meal. Thus there is little incentive to economize, and everyone will spend more than they really want to.

Members of Congress find themselves in a similar situation with regard to Federal spending. The widespread recognition of this problem has led to broad support for institutional reforms. The purpose is to change the ground rules under which congressional decisions are made to improve the results of the budget process. Proposals to change the rules to require a spending cap or balanced budget is a logical response.

By the fall of 1985, it was obvious that the budget process had failed. This problem became so frustrating that the Gramm-Rudman-Hollings amendment was enacted quickly into law, with tremendous popular support. While the Supreme Court recently struck down a key component of the automatic sequestration process, it marks the first major step by Congress to limit the fiscal illusion. The next logical step is that the Congress pass the balanced-budget/tax-limitation constitutional amendment.

Under the Constitution, Congress is given the power of the purse, with some limited exceptions. Despite the strong efforts of President Reagan to encourage congressional self-restraint, Federal spending is still out of control. Some form of balanced budget constitutional amendment is needed to restore balance to fiscal decisionmaking in Congress. Meantime, Congress must redouble efforts to contain spending growth without increasing taxes, including holding itself to the spirit of Gramm-Rudman-Hollings.

Monetary Policy: Controlling Inflationary Expectations

The Reagan Administration came into office in 1981 with a program for economic recovery. One of its major policy commitments was a stable monetary policy to reduce inflation. It is clear that the

Reagan Administration has achieved its inflation objective, but that raises an important question about monetary policy: What techniques or methods actually worked? Some widely held theories of monetary management have been challenged by the evidence of recent years.

On the basis of that evidence, the most important factor in reducing inflation seems to have been the unswerving commitment by the President to restore confidence in the dollar both at home and abroad. This unbending policy principle has served to anchor the expectations of the financial markets during five years of puzzling economic news about the Federal budget deficit and the U.S. trade deficit, and conflicting economic theories attributing various consequences to deficits.

Since 1981, the rate of increase in consumer prices has come down from 13.5 percent in 1980 (the actual peak was 15.5 percent in March 1980), to 3.8 percent in 1985 and a still lower rate in 1986. In the President's statement of his program for economic recovery in 1981, this was to be the result of "a stable monetary policy." The Federal Reserve, however, has not achieved this success by means of a monotonic slowing of the rate of increase in the money supply.

The interesting questions raised by the success of monetary policy in the past five years are shown by the following comparisons of monetary growth rates and monetary stability in two equal periods, from the second quarter of 1976 through the first quarter of 1981 and from the second quarter of 1981 through the first quarter of this year. (See Charts II.1 through II.4.)

CHART II.1

QUARTER–TO–QUARTER INCREASES IN M1

(ANNUAL RATES, 1976–81)

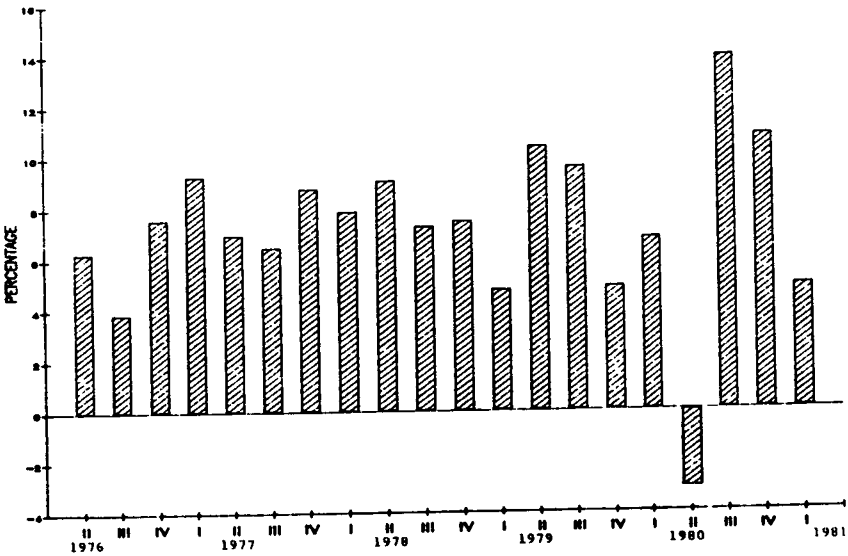
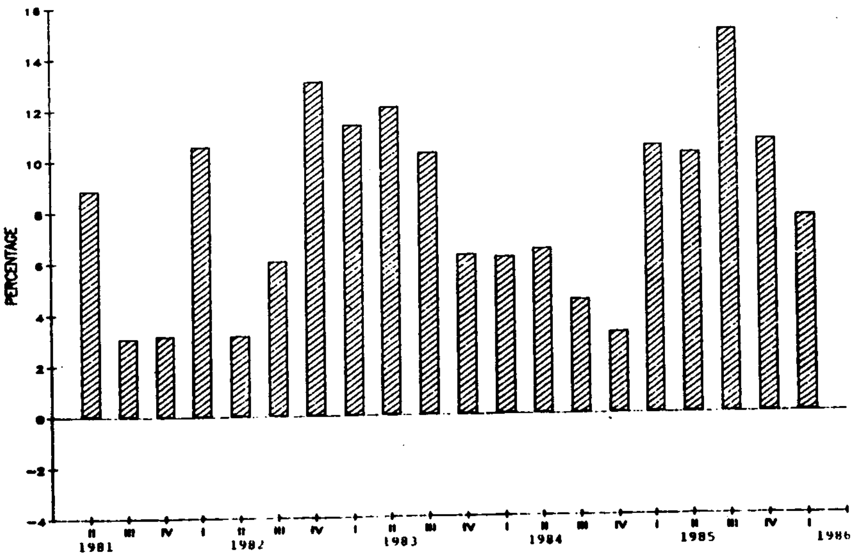


CHART II.2

QUARTER–TO–QUARTER INCREASES IN M1

(ANNUAL RATES, 1981–86)



In the earlier period, the average rate of growth in M1 was actually smaller than during the Reagan Administration. The mean quarterly increase in M1 during the 1976–81 period was 7.2 percent (Chart II.1), whereas in the Reagan Administration it was 8.1 percent (Chart II.2) through the first quarter of 1986. The quarter-to-quarter swings in monetary growth during the Reagan Administration have been about the same as in the earlier period—indicating no change on monetary stability. The standard deviation of the quarterly changes in the growth rate of M1 during the 1976–81 period was 5.2 percentage points (Chart II.3) and in the 1981–86 period it has been 4.2 percentage points (Chart II.4), indicating very little change in volatility from one period to the next.

CHART II.3

QUARTER–TO–QUARTER CHANGES IN M1 GROWTH RATES

(1976–81)

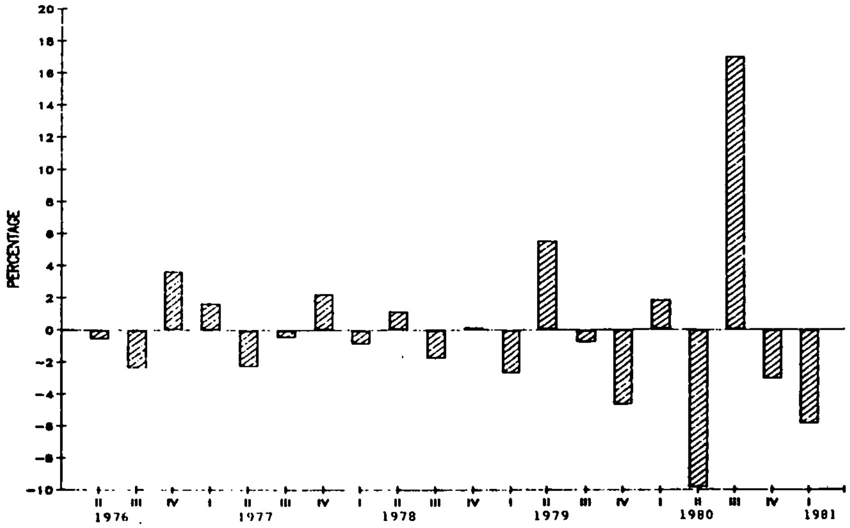
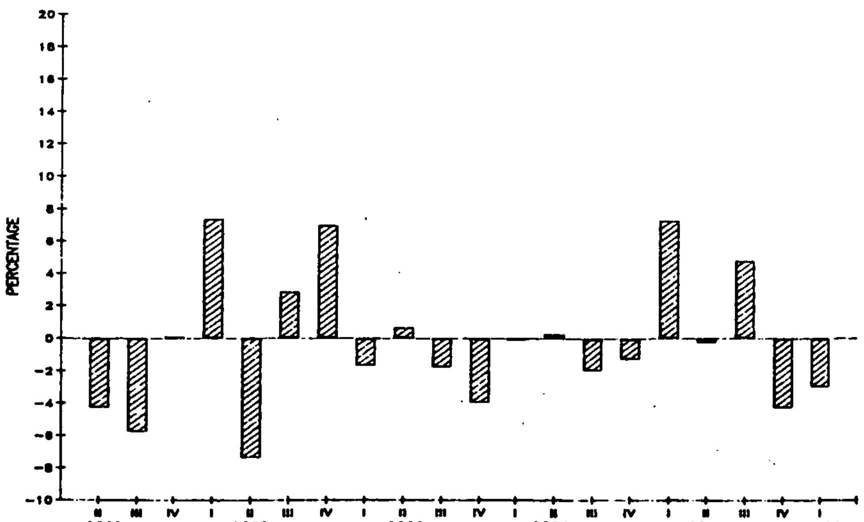


CHART II.4

QUARTER–TO–QUARTER CHANGES IN M1 GROWTH RATES

(1981–86)



The Federal Reserve in 1980 was faced with an extremely difficult problem. It was not possible to fulfill its statutory mandate to promote "maximum employment, stable prices, and moderate long-term interest rates." The inflation of the 1970s had led to both rising unemployment and high interest rates. A transition from inflation to stable prices would temporarily make the situation worse, because it necessarily requires changes in the economic plans of businesses and individuals—costly and politically unfavorable changes. Unemployment and financial-sector weakness are the natural results of such a change in the economic rules-of-the-game from high inflation to stable prices, because some unpleasant interruption of private sector economic planning must occur. Some investments that were rationally made in the expectation of profits, and many jobs created in the expectation of productive reward are exposed as illusory when the smog of inflation is blown away.

It was clear to the chairman of the Federal Reserve even in 1979, when a major change in operating procedures was announced, that inflation had to end. Yet only the operating environment created for the Federal Reserve by the Reagan Administration's firm stand against inflation—and the degree of public credibility the President was able to achieve for his firmness in that policy—made it possible for the Federal Reserve to meet its statutory responsibilities.

In May 1981, the Federal Reserve *reduced* M1 by 6.7 percent and held the quarterly rates at approximately 3 percent until July 1982, with the exception of the Christmas season and the income-tax month of April. The real quantity of money during this period actually decreased, as consumer and producer prices continued to rise at a greater, but slowing, rate. Yet, because the President made the Federal Reserve the front line in his fight against inflation, the Fed was insulated from congressional pressure.

Today, in retrospect, we see how President Reagan seized control of the critical economic variable of expectations in 1981. With a credible defense against inflationary expectations, due to President Reagan's iron-handed anti-inflation stance, the monetary authorities after mid-1982 have had sufficient maneuvering room to stimulate economic growth and deal with problems requiring financial intervention (e.g., the Continental Bank and Bank of New York episodes). Massive increases in the money supply have subsequently occurred, but without any perception on the part of the financial markets or the public that inflation would result.

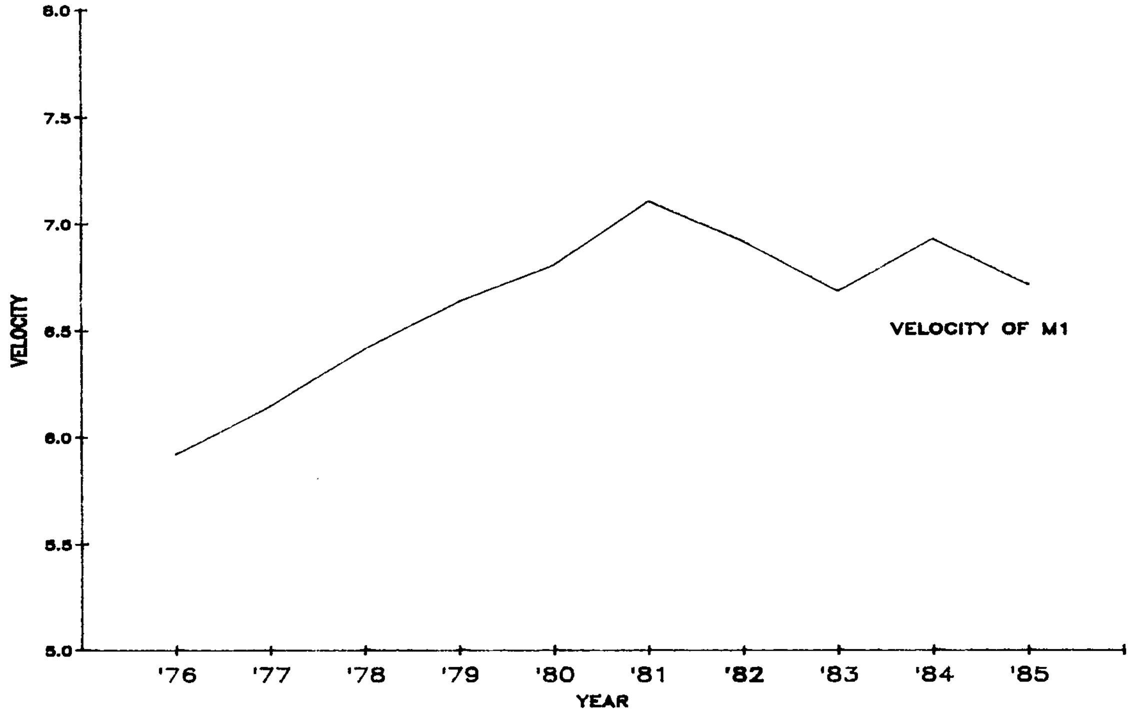
Indeed, the restoration of confidence in the U.S. dollar has been so successful that historically large increases in the money supply have been absorbed by the public in depository accounts. The much noted downturn in the velocity of money, for example (see Chart II.5), is a testament to the success in reducing inflation and interest rates. The willingness of the public to hold government promises, i.e., purely fiduciary currency, as an asset in times of economic growth without rekindling expectations of inflation reflects confidence in the Nation's policital leadership.

62-113 0-86 - 3

CHART II.5

VELOCITY OF MONEY

(1976–85, DECEMBER OVER DECEMBER)



The lesson to be learned from this experience is that shifts in the demand for money can have tremendous effects on the price level and the rate of economic growth, even swamping the impact of changes in the money supply.

Changes in the demand for money, however, do not occur for unexplained reasons. In 1981, a turning point in American economic history occurred with the inauguration of Ronald Reagan, and the U.S. economy has responded robustly to the positive impact of the Reagan Administration's new economic policy.

ENERGY POLICY

Wearing a cardigan sweater and sitting beside an open fire, President Carter declared to the American people on February 2, 1977 that this Nation's crusade against the energy crisis was to be "the moral equivalent of war." Increased American dependence on imported oil and the quadrupling of world oil prices had encouraged Carter to ask the Nation to accept a national energy plan which emphasized both conservation and an enhanced role for the Federal Government in energy planning. Thermostats were lowered to 65 degrees and the speed limit was reduced to 55 miles per hour. Probably nothing better exemplified the zero-growth attitude of the Carter Administration than the introduction and eventual passage of an energy policy which asked Americans to lower their economic expectations and consume less energy.

President Reagan took office determined to diminish the Federal Government's role in attempting to manage the economy. And since there was little that the government could do more efficiently than the marketplace, why make energy policy an exception? Critics argued at the time that it would be folly to leave issues as important as energy conservation and petroleum allocation and supply to the vagaries of the marketplace. Prices, they said, would skyrocket. Administration officials countered that it was impossible for the government to predict just what type of energy should be produced and how it should be consumed.

On January 28, 1981 the Reagan Administration lifted all price and allocation controls on gasoline and crude oil, though largely retaining fuel efficiency standards for cars. Since that time Americans have consumed less oil, both domestic and imported, while producing more at home. Moreover, the price of imported crude oil has declined in the last five years by more than 50 percent. Reduced American dependence on foreign oil best dramatizes the Administration's success in decontrolling the price of oil. Last year the United States imported less than 27 percent of all petroleum products consumed, as compared with 35 percent five years ago.

ENERGY PRICES—A LESSON IN SUPPLY AND DEMAND

The world oil market will probably serve for years to come as a classic example of how markets function. The supply reductions of 1974 and 1979 caused a jump in world oil prices. In the United States, where price controls restricted the price movements, a shortage resulted that helped support the cartel activities of the Organization of Petroleum Exporting Countries (OPEC). After the shocks, domestic oil producers did not increase their production in response to the OPEC activities because the price they were receiving did not rise sufficiently to cause them to expand drilling operations. Domestic supply actually began to fall. Consumers being partially sheltered from the price increase had no reason to reduce consumption. With this combination, imports as a percent of total crude oil use rose following each of the oil shocks. The rise was particularly severe after the 1974 shock, as the percent of imports went from approximately 40 to over 50 percent.

When prices were finally freed by the current Administration in 1981, eliminating the differential between imported and domestic oil prices, market forces began to correct the imbalances. Domestic production began to rise in 1982, and consumers reacted by generally reducing energy consumption and increasing their demand for fuel efficient cars, appliances, and housing. The combination of increasing the world supply and reducing the quantity demand had almost immediate effect on the price of oil. With this drop in prices, the OPEC nations also began increasing their output in an attempt to maintain revenues. This loss of cartel discipline further depressed prices and has undermined and perhaps destroyed the ability of OPEC to raise prices.

This demonstrates the ability of market forces to correct underlying imbalances. Import quotas and other governmental interferences try to reduce the transitional cost, but they actually raise the cost to the economy by causing distortions as businesses and consumers make production and buying decisions based on prices that have little relationship to economic costs. Government attempts to supercede the market rarely, if ever, result in a less costly solution.

In particular, the peculiar combination of moral suasion and mandated energy reductions advocated by the Carter Administration was unsuccessful. (Did the "thermostat monitors" ever collect any $10,000 fines?) The purpose of these maneuverings was to reduce energy use while advoiding undesirable distributional effects. A more efficient solution is, however, to let prices rise, let the resource go to its highest value use, and ease adjustment costs, if necessary, by transfer payments, not price and production controls.

Another danger of attempting to circumvent the price mechanism is the spill-over effects to other markets. Consider oil and natural gas, two fairly close substitutes. As these major sources of energy have gone through various degrees of price controls, changes in the supply or demand for one have automatically caused an oversupply or undersupply of the other because of the lack of automatic price adjustments. Because resources must be allocated by some means if prices are not used, then further regulations are inevitable. This was the rationale underlying the Powerplant Industrial Fuel Use Act passed during the Carter Administration. This Act was designed to lower demand for natural gas by prohibiting the use of natural gas by electric generation and industrial facilities.

THE IMPACT OF LOWER OIL PRICES

The first and probably the major beneficiary of the decline in oil price will be the consumer. As the lower input price is reflected in lower costs of final goods and services, real personal income will rise leading to an increase in consumer demand. The higher demand level will support higher levels of output, particularly in consumer durables. Industries that are energy intensive, such as steel and airlines, should also feel an immediate impact.

Lower oil prices have brought problems to some industries and regions. These negative effects, however, tend to became evident more quickly than the benefits, for it takes oil companies only a short time to cancel drilling operations and much longer for consumers to adjust their spending patterns. In the longer term, the outlook is optimistic. Witnesses before a JEC hearing testified that the drop in oil prices would give a sharp boost to the economy, perhaps a half to a full percentage point in growth. Whatever this magnitude may be, lower energy prices are a net benefit for the economy in the aggregate.

THE CHANGING ENERGY PICTURE

While natural gas and oil still supply the majority of our energy needs, coal remains our most abundant commodity and an important energy resource. Experts predict that our Nation's coal supplies will last for more than three centuries. And since the oil embargo of 1973–74, coal's contribution to total U.S. energy consumption has expanded from 17 percent to 23 percent. The increased use in recent years of coal in supplying our energy needs makes the environmental protection of our air an important national objective. There is a clear need to respond to the damage inflicted on our lakes, streams, and forests, especially in the Northeast, from acid rain deposition. Sulfur dioxides and other air pollutants released from utilities and other industrial plants continue to threaten our environment. Evidence of damage affects many states in the country as well as in Canada. A significant curtailing of the rate of these emissions should be a policy objective. And though environmental problems concerning the burning of coal persist, the implementation of the Clear Air Act, at a significant cost to coal-fired powerplants, has done much to protect the citizenry around these plants. Methods are being studied to improve the combustion process and remove a greater percentage of pyritic and organic sulphur from coal, and to clean the gas after it leaves the combustion chamber.

In 1985 nuclear power plants supplied almost 15 percent of the Nation's electricity, and today there are almost 100 nuclear reactors in operation. Last year, in an attempt to simplify the licensing process, the Administration proposed to Congress the adoption of the Nuclear Facility Standardization Act. This simplification of the licensing process and the continued implementation of the Nuclear Waste Policy Act of 1982 are the cornerstones of the government's nuclear policy.

Electric power plants have been at the forefront in reducing America's dependence on foreign oil. In 1977 these plants relied on oil for 17 percent of their total energy input. Today that figure is less than 5 percent, as coal, uranium, and renewable energy sources have replaced imported oil. Yet, while the Nation's total consumption of primary energy has been roughly the same since 1973, the demand for electricity has grown by more than one-third during the same period. In 1983 the National Energy Policy Plan reported that projections of future electricity demand indicated that a "substantial amount of new generating capacity will be needed." Three years later, this description is still accurate.

Renewable energy, mostly in the form of hydroelectric power, accounts for about 14 percent of the Nation's electrical needs and 9 percent of the total domestic energy supply. Renewable energy supplies are expected to double by the end of the century, coming mostly from geothermal energy, wind, solar-thermal, passive solar, photovoltaics, and biofuels. The continued development of renewable energy sources is expected to increase U.S. exports of energy technologies.

Recent international developments have raised issues in energy policy. Some have proposed placing a fee on imported oil, but the Administration has opposed this as burdensome to both consumers and industry. As for the security of our energy supplies, the Administration points out that the Strategic Petroleum Reserve has grown five-fold since 1980. It now gives the Nation almost two years of protection from any possible future oil embargo. More serious, perhaps, were the questions raised after the accident at Chernobyl about the future of nuclear power. The Department of Energy has reinforced the superiority of our nuclear safety precautions vis-a-vis the Soviets and is studying potential technological breakthroughs that would greatly reduce the probability of nuclear accidents. Tests are being conducted in Montana with the purpose of creating a no-risk cooling system.

In July 1979, President Carter spoke directly to the American people about the Nation's malaise and accused Americans of squandering energy. When President Reagan assumed office he changed the equation. This country's energy consumption habits were not a moral failure; they were founded on economic decisions made in the marketplace. Today, after five and a half years of reduced Federal regulation and an enhanced free market role, the Nation now produces more energy, consumes roughly the same amount, and spends less for it.

Capital Formation

The Reagan Administration recognized that increasing the rate of capital formation is crucial to restoring economic growth. Toward this goal, the Administration and Congress instituted a set of tax and regulatory policies intended to increase investment in plant and equipment. These policies have been successful. Capital formation is increasing in both quantity and quality, signaling a willingness of business to invest in the future.

INCENTIVES FOR CAPITAL FORMATION

To reduce the previous discrimination in favor of current consumption over investment, the Economic Recovery Tax Act of 1981 (ERTA) made major changes in the taxation of income from business investment. The most important of these changes was the adoption of the accelerated cost-recovery system (ACRS) for depreciation. Under this system, which allows for faster write-off of plant and equipment expenditures, effective tax rates on new investment were significantly reduced. In addition, the investment tax credit was increased for some types of equipment. Lower tax rates reduce the cost of capital by lowering the before-tax rate of return a business would need to earn in order to achieve a specific after-tax return.

These changes to the tax code were further supported in stimulating capital formation by the general improvement in the economy, particularly the drop in inflation and interest rates. Between 1976 and 1980 the producer price index (PPI) grew at an average annual rate of close to 10 percent. From 1980 to 1985 the rate of increase slowed to 3.5 percent, and it appears that the PPI may actually fall this year. The lower the rate of inflation, the greater the value of depreciation allowances. Even with the shorter ACRS depreciation schedules, if inflation had continued at its previous rate, a loss in the dollar's value of 10 percent per year would have severely reduced the benefit arising from the tax changes. The recent fall in interest rates is more good news for investors since it lowers the required rate of return on proposed investments. The interest rate on 3-month Treasury securities has dropped from a high of 15.7 percent in 1980 to just above 6 percent.

CAPITAL FORMATION AND PRODUCTIVITY

Achieving adequate levels of capital formation is important because it improves productivity. Increases in capital investment increase the capital available per worker, and new plant and equipment incorporate new technology; both produce higher output per worker. Productivity gains bring increases in our standard of living, as real wages increase and prices fall.

Beginning with ERTA, we began reversing the patterns that are responsible for a 20-year productivity slump. There is reason to be optimistic that the capital expenditure of the last three years will soon be translated into economic growth and improvement in productivity.

Empirical analysis of the 1967–73 and 1973–78 declines in productivity places a large amount of the responsibility, especially in the later period, on inadequate capital formation. Therefore, one positive sign is that current capital spending (measured by real private domestic nonresidential investment as a percent of GNP), was higher in 1984 and 1985 than at any point of the postwar period. But capital spending as percent of GNP was also fairly high by historical standards during the 1970s. Will this new capital investment have more impact on increasing productivity than the investment of the 1970s? Several factors suggest that it will.

GROWTH IN THE CAPITAL-LABOR RATIO

The absolute amount of new capital does affect productivity because the new capital should embody technological advances that are not in the existing plant and equipment. But capital investment increases labor productivity by raising the amount of capital per worker only if the number of workers do not increase at a faster rate than the capital investment. As shown in Table II.4, employment grew faster than capital investment between 1966 and 1976, causing a drop in the capital-labor ratio. The growth in the ratio between 1976 and 1980 was barely sufficient to raise the level above the 1966 level.

TABLE II.4.—GROSS PRIVATE CAPITAL, EMPLOYMENT, AND CAPITAL PER EMPLOYEE

Year	Gross private domestic fixed nonresidential structures and equipment (millions of 1982 dollars)	Employment (thousands)	Capital per employee (1982 dollars)
1956	$160,400	63,799	$2,514
1966	250,400	72,895	3,435
1976	290,600	88,752	3,274
1980	379,200	99,303	3,819
1985	471,800	107,150	4,403

Source: U.S. Department of Commerce and Bureau of Labor Statistics.

While the number of people employed in the United States continues to grow, we do not expect to see the large increases that occurred in the 1970s. The two components of employment, the labor force participation rate and the population, do continue to rise, but the rate of increase has slowed considerably. Between 1980 and 1985 the labor force participation rate grew at an average annual rate of 0.3 percent and population growth slowed to 0.95 percent annually. This contrasts sharply with a growth in labor force participation that was over twice as high (0.7 percent) and a population growth rate of 1.1 percent (both annualized rates) between 1976 and 1980.

These lower growth rates will help raise productivity in two ways. First, with the slower growth rate of workers, a given capital investment will raise the average capital available per worker. Second, a slower rate of growth of new workers implies an average maturing of the work force and workers with more experience will tend to have a higher rate of productivity.

POLLUTION ABATEMENT EXPENDITURES

The establishment of pollution standards in the early 1970s required new capital expenditures to bring existing plant and equipment up to new standards. Therefore, it is expected that the initial percentage of capital expenditure on pollution control would be greater than what should be expected for the long run. While expenditures of this kind do improve our environment, they do not directly increase productivity as it is ususally measured.

Real dollar expenditures on new plant and equipment for air, water, and solid waste pollution abatement reached a peak in 1975 and declined to less than 70 percent of the peak level in 1984. As a percentage of total new plant and equipment, expenditures have dropped from 4.2 percent in 1975 to 2.1 percent in 1984. In the manufacturing sector the decline was greater, starting with 8.7 percent in 1975 to 3.3 percent in 1984. Thus, business investment appears to be moving into channels that will have a more direct and immediate impact on output per worker than during the 1970s.

OUTLOOK FOR CAPITAL FORMATION

The consensus of forecasters points to relatively slow growth in new capital investment in 1986, owing mainly to the drop in oil prices. But this low growth should be temporary. Eventually, the drop in oil prices will increase business investment through the stimulative effect on the economy overall.

Passage of a tax bill with lower tax rates for both individuals and corporations should be favorable for productivity, particularly since the wholesale elimination of loopholes will encourage capital to flow into its most productive uses. Furthermore, just the passage of a major tax bill—quite aside from its actual provisions—should stimulate capital formation. Tax reform has percolated through Washington for nearly two years, and the resulting uncertainty has induced business to hold off on many major capital projects. Once a tax bill is passed and the rules become clear, a significant pent-up demand for capital goods may well materialize.

THE AGRICULTURAL AND RURAL ECONOMIES

After five years of agricultural recession and an even longer period of deteriorating trends, a number of economic indicators are signaling that a turnaround may be taking place. Because of the length and severity of the farm recession, the recovery likely will be slow and perhaps erratic, and it will be dependent on the performance of the domestic and global economy as well. While we're hopeful that these reversals of trends point to a brighter financial future for American farmers, we're very cognizant of the economic devastation which the agriculture community has already suffered.

Providing the greatest evidence for optimism are the significant drop in oil prices and declining interest rates. These two items have led the way to a decline in production expenses. Coupled with generous levels of government payments to farms and a continued trend of greater off-farm income for farm households, the future financial picture for farm families is improved from two years ago. This added financial stability has contributed in turn to an improvement in farmland value trends. After plummeting $100 billion in 1984, real estate values have steadied, to the relief of all farmers and bankers. As an added benefit, retained value in real estate provides the collateral necessary for farm credit.

On the domestic scene, continued expansion of the U.S. economy contributes to a better agricultural picture in many ways. Inflation, interest rates, and exchange rates have all moved in a favorable direction. Monetary and fiscal policies suggest greater stability in the long run. Tax reform promises to rid the farm sector of undesirable tax shelters that were held by nonfarmers and to lower tax rates and tax liabilities on farm families. The international economy is pointing to brighter prospects for agriculture as well. The decline of the value of the dollar is expected to make a positive contribution to the competitiveness of U.S. exports.

The following table details the trends of several statistical indicators over a nine-year period.

TABLE II.5.—SELECTED AGRICULTURAL TRENDS (1978-86)

Items	1978	1979	1980	1981	1982	1983	1984	1985	1986
Total farm debt (billions)	$141	$166	$182	$202	$217	$216	$213	$205	[1] $200
Interest rates:									
Real estate loans (percent)	9.6	10.5	13.2	15.4	15.5	12.5	13.5	12.7	[1] 12.0
Production loans (percent)	9.3	10.8	14.8	17.9	17.1	14.3	14.4	12.8	[1] 12.5
Prices paid by farmers for production items (1977=100)	108	125	138	148	150	153	155	151	[2] 145
Government payments to farms (billions)	$3.0	$1.4	$1.3	$1.9	$3.5	$9.3	$8.4	[1] $8.0	[1] $11.5
Non-farm income on farms (billions)	$30	$34	$35	$37	$38	$39	$40	[1] $41	[1] $42
Exchange value of U.S. dollar (1973=100)	92	88	87	103	117	125	138	143	[3] 116

[1] Estimated.
[2] May.
[3] March.

Source: Department of Agriculture and Federal Reserve System.

While each of these six indicators shows added support and strength to the farm economy, higher commodity prices are essential to achieve a recovery in agriculture. A summary of positive indicators would include the following listing:

Farm debt is declining. After peaking at $217 billion in 1982, farmers have pared back $12 billion to date and are expected to reduce debt loads another $5 billion by the end of 1986.

Interest rates are falling. While interest rates charged to farmers have fallen five points from 1981 levels, they remain substantially higher than national money market rates. Further declines may be expected, however, with low inflation and reduced risks in farm lending due to more stable land values and brighter financial prospects.

Farm operating expenses have stabilized. Prices paid by farmers have fallen to the lowest levels since 1980, thanks to the oil price collapse, lower interest rates, and a virtual halt in inflation in agricultural inputs. This trend is a welcome relief from the hyper-inflation years of the late 1970s, which saw a 40 percent hike in prices paid by farmers in four years.

An improved farm program is more effective and helpful. The 1985 farm bill maintains income supports at record levels while taking steps to improve U.S. agriculture's standing in the international trade arena. For example, the recent reduction in the U.S. loan rate for grains has forced the European Community to increase its export subsidies by $1.5 billion. European consumers must pay for that action through an increase in the value-added tax. Such pressure on our foreign competitors will strengthen U.S. interests in the years ahead.

The exchange rate of the U.S. dollar has fallen. The dollar has fallen over 20 percent since the summer of 1985. It has dropped even further against the Japanese yen, and Japan is a key market for U.S. agricultural exports.

Off-farm income of farm families continues to rise. Alternative employment opportunities add a desirable element of financial stability to farm households. These other income sources have increased 20 percent since 1980, and now account for over two-thirds of farm household income.

Has the farm economy bottomed out? Perhaps not, but we are hopeful that lower interest rates, debt loads, input prices, and the value of the dollar are leading economic indicators of a financial recovery for U.S. farmers and ranchers.

Vast parts of rural America have been affected not only by the agricultural recession, but also by declines in other natural resource industries. The dependence on these traditional industries during a difficult period has punctuated the need for rural communities to diversify their economic bases. Fortunately, however, service and manfacutring industries contributed to the ability of rural areas to cope with declines in other sectors.

Contrary to popular belief, real incomes of rural and farm areas during the first term of the Reagan Administration exceeded by far the dismal performance of the Carter years. The following table compares per capita personal incomes, adjusted for inflation, for the years 1978, 1981, and 1984:

TABLE II.6.—PER CAPITA PERSONAL INCOME

[Constant 1984 dollars]

Geographic entity	1978	1981	1984	Percent change 1978–81	Percent change 1981–84
United States	$12,373	$12,041	$12,772	−2.7	6.1
Metropolitan United States	13,120	12,778	13,603	−2.6	6.5
Nonmetropolitan United States	9,988	8,683	10,092	−3.1	4.2
10 Midwest farm States (nonmetropolitan areas only)	10,913	10,602	1,067	−2.8	4.4

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

The Midwestern states referred to in the table are Illinois, Indiana, Iowa, Kansas, Minnesota, Missouri, Nebraska, North Dakota, South Dakota, and Wisconsin. The table clearly shows that metropolitan, nonmetropolitan, and farm areas experienced declines in real per capita personal income from 1978 to 1981 and rebounded in the next three years. In fact, the nonmetropolitan areas of the Midwestern farm states slightly out-performed other nonmetropolitan areas. Evidently, the stagflation years of the late 1970s were more detrimental to personal income of residents of small communities and rural areas than the years of agricultural recession that followed. Despite the fact that nonmetropolitan areas lag behind the rapid gains of metropolitan areas, significant improvement has been realized thus far in the 1980s.

Trade

Conditions are ripe for a modest but important reduction in the merchandise trade deficit which, between 1981 and 1985, had moved from −$40 billion to −$148.5 billion. Support for this view is found in preliminary estimates for 1986. Those estimates indicate that for the first time since the beginning of this decade—and notwithstanding another large deficit in the range of $140–$150 billion this year—America's external trade imbalance will not increase further, and could indeed be significantly reduced by the end of the decade.

What factors account for this coming reversal in the U.S. trade deficit? The major cause is to be found in the devaluation of the dollar. Since the spring of 1985, its value has declined by approximately 30 percent on a trade-weighted basis against the currencies of our British, French, West German, and Japanese trade partners. Trade flows are not immediately responsive to devaluations. If the recent U.S. experience fits the traditional pattern, however, this upward shift in the exchange rate against the dollar will be reflected in higher U.S. import prices for Western European and Japanese goods no later than the fourth quarter of 1986. Another result will be a long overdue jump in American export sales, which over the long term must increase significantly if the United States is to achieve approximate balance in its external accounts.

The other factor behind forecasts of improved U.S. trade performance involves enhanced growth prospects in allied and Third World countries. In substantial measure, this is a direct result of a $10 cut in oil prices, which according to Wharton Econometric Forecasting Associates will add about 1 percent to developed country growth between 1986 and 1987. The global picture, to be sure, is complicated by the disparity between Western gains in response to oil price declines and the significant drop in growth prospects for a number of heavily indebted, oil-exporting Third World countries—whose severe debt burdens and corresponding export revenue losses will continue to retard sales of American products there. Offsetting this somber picture, though, are favorable growth prospects for Pacific rim countries and the industrial West. Wharton's estimates run the gamut of 2.3 percent for Italy, 2.6 percent for the United Kingdom, 3 percent for France, 3.2 percent for Japan, and 3.7 percent for West Germany.

Over the long term, however, these market shifts need to be matched by more aggressive actions on the part of the United States on behalf of free trade, and for compelling reason. The world is awash in protectionism. The United States must accordingly initiate reforms of trade practices which undermine American competitiveness at home and abroad. These practices run the gamut from "infant industry" protection to wasteful export subsidies.

But the Congress and Administration have undertaken major actions to reverse these unfavorable trends by (*a*) insisting on stricter enforcement of American import laws, (*b*) calling for new rules governing trade in services, including insurance and intellectual property, and (*c*) demanding significantly faster liberalization of foreign markets for U.S. agricultural and manufactured goods in Asia, Latin America, and Western Europe.

Spurred on by growing congressional pressure, the Administration has been increasingly aggressive in pressing for improved market access for American business. These actions include:

Moves against trade barriers in Japan, Korea, and Brazil, under Section 301 of the Trade Act of 1974.

Acceleration of ongoing General Agreements on Tariffs and Trade (GATT) cases involving European Community restrictions on imports of canned fruit from the United States and Japanese prohibitions on imports of American leather and footwear products.

Acceleration of negotiations to end the counterfeiting and piracy of U.S. goods and processes, and to better protect American intellectual property rights.

Conduct of Market-Oriented Sector-Specific (MOSS) negotiations with Tokyo to improve market access for American telecommunications, medical equipment and pharmaceuticals, electronics, and forest products firms in Japan; the next MOSS round will also include auto parts.

On top of these specific actions are more generalized U.S. efforts to strengthen economic policy cooperation between allied countries. A major step in this direction was taken last September 22 by members of the "G-5" (United States, Great Britain, France, West German, and Japan) to promote more robust and balanced growth in these economies.

What remains to be done in trade policy? At the top of the list is convincing this country's partners that the present imbalance between America's merchandise deficit and their corresponding surpluses is neither sustainable nor in their long-term interests. Convincing them will not be easy. But it can be accomplished if the United States is prepared to seriously pursue three fundamental goals:

1. *Support for Growth in Allied Countries:* Realignment of the exchange rate will not, in itself, bring about long-term improvements in America's trade account in the absence of major structural changes in the economies of our partners. Illustrative of the problem the United States will face in the future is Japan, with its inordinately high levels of savings and austere standard of living. Of course, a cheaper U.S. dollar should help to improve the U.S. trade balance vis-a-vis Japan. The matter cannot be left there, explains Forbes magazine: "The Japanese are as addicted to saving as we are to spending, and ship much of their savings overseas. By 1990, Japan's net foreign assets could easily hit $400 billion or $500 billion."

Japan's huge trade surpluses—estimated to reach $80 billion this year—are a direct reflection of its domestic savings propensities. The United States needs to encourage Japan to alter those practices by promoting growth at home. How? Through initiatives to encourage consumer spending, along with more targeted actions designed to put an end to wasteful subsidy programs which keep domestic prices high while keeping out competitive U.S. imports. If these steps are taken, Japan will soon discover that it has significant scope for disposing of its foreign dividends and trade surpluses at home.

But Japan is hardly alone. Consider West Germany. According to a new JEC Report, the Federal Republic appears to be on the verge of a major economic recovery, which could be used to promote a resurgence of growth throughout Western Europe. In light of Europe's massive unemployment and stagnant job growth, such a course of action makes sense on its own "European" merits.

There is an even stronger case to be made on behalf of European expansion, however. Global economic stability would be considerably increased if Europe played a larger, more dynamic role in promoting trade-driven growth. The lead country in any such endeavor is clearly West Germany. Washington has accordingly urged

Bonn to take advantage of its imposing assets—close to zero inflation, bulging external accounts, and a pick-up of domestic demand—to help trigger a broader, European-based recovery. Specifically, more ambitious tax cuts and removal of structural barriers to growth are recommended. Since German policies have not yet been changed, the message must be repeated: If America's allies are seriously committed to maintaining an open U.S. and global market, they need to undertake immediate actions designed to equalize the trade burden.

2. *New Negotiations:* The United States must continue to negotiate trade rules which maintain an open global economy. This will not be easy. Since the end of World War II, considerable progress has been make breaking down barriers to free trade. In their place, however, have come new barriers. Failure to demand fair market access—running the gamut from South Korea and Japan to France and Brazil—will surely result in serious export losses for the United States.

The United States should pursue these market opening goals on two fronts: on the bilateral, sector specific level, as it has already been doing; and on the multilateral GATT level which should provide the forum for launching the next global trade round later this year.

As these negotiations move forward, the United States needs to devote particular attention to modernization and reform of trade laws. Beginning with the GATT itself which, over the past few years, has seen its authority erode in the face of protectionist assaults by its members. It serves everyone's interests to work toward a strengthened GATT.

3. *Integration of the Advanced Developing Countries (ADC's) in the New Trade System:* The most promising export opportunities for the United States lie in the coming giants of the future: Brazil, South Korea, India, China, and a host of smaller, export-growth oriented economies in the Pacific region. In recent years, these countries have made significant strides in adapting themselves to free market principles. But this process needs to be accelerated, especially on the trade front, given the substantial import barriers in those countries which seriously discriminate against U.S. goods. Developing countries complain about the rise of protectionism in the United States. What they fail to publicly acknowledge, however, is the degree to which their own anticommercial practices—ironically enough endanger their access to the American marketplace. A case in point supplied by Brazil, which sees no inconsistency in its demand for open markets in the United States and passage of laws in Brazil that effectively block imports of American software and personal computers.

III. ECONOMIC PERFORMANCE: A LOOK AT THE DATA

ECONOMIC GROWTH

When reviewing the record of economic performance, it is important to remember where we started and where we are headed. The Reagan Administration took over when inflation and interest rates were high and rising. The situation was threatening to get out of control, with inflation accelerating ever faster and the economy fading into recession. Inflation was not just an abstract concept emanating from the Bureau of Labor Statistics; it was a deep concern of nearly all Americans. The value of lifetime savings was melting away. People were frantically searching for investments that promised some hope of safety—gold, antiques, stamps, and the like—but without much confidence that they would escape ruin. Real estate appeared to be an attractive inflation hedge, except that mortgage interest rates were nearly double what they are now. Business firms shied away from potentially productive investments in plant and equipment, since under rapid inflation they would never be able to properly depreciate their investments for tax purposes, so as to recover the principal necessary for eventual replacement of the equipment. Inflation was distorting economic decisions away from productive, growth-inducing investment and into anything that promised a hedge against inflation-induced losses.

Thus, the growth record of the Carter Administration was much worse than would be evident from the GNP figures. Real GNP grew at an average rate of 3.0 percent between 1976 and 1980. Not bad. But the early growth was primarily a recovery that was underway before President Carter's policies had any effect. The growth in the middle-Carter years was mainly a short-lived spurt induced by rapid monetary growth. And the final year of the Carter Administration now can be seen as the last gasp of an inflationary expansion, with the economy headed for the recession that had been made inevitable by that inflation.

No president can be held responsible for overall economic performance during his first year in office because it is impossible to make any significant changes in tax policy and possible to make only the smallest changes in spending. Monetary policy, which also is characterized by lags, may or may not reflect the policy of the administration. So while the growth rate during the Carter Administration was nominally 3.0 percent a year, it was much less when we consider the period during which the Carter policies actually had an effect. When we eliminate 1977 from consideration, average growth falls to 2.5 percent. And if we give the Carter Administration credit for 1981 (before President Reagan's policies could take effect), real GNP growth is 2.4 percent, well below the Nation's long-term average rate of between 3.0 and 3.5 percent. Perhaps it is going too far to credit Carter with 1982, but if we did his growth record would plunge to 1.4 percent.

Whatever the measure of growth during the Carter years, the economy was slowing down when the Republicans took office. A car's speedometer may read 50 miles per hour, but it makes a big difference whether the driver's foot is pressing the accelerator or stomping on the brakes. The Republicans inherited an overheated economy that was skidding to a halt.

In 1982, the economy fell into a recession that was unforeseen by practically every professional forecaster in and out of government. Real GNP declined by 2.5 percent. Money growth had been temporarily slowed drastically to fight inflation. Importantly, the 1981 legislation to cut taxes had not taken effect in any meaningful sense, and this had an adverse effect on spending. The situation was like that of a furniture store that announces its big sale a month in advance; demand dries up while potential customers await the lower prices.

By 1983, inflation had subsided and the main policies of the Reagan Administration were in place at last. A long expansion began—lasting from the fourth quarter of 1982 and still continuing—with an average annual growth rate of 3.3 percent.

Furthermore, the economy is moving ahead steadily, thanks to the decline of inflation and interest rates. Expectations of inflation have been greatly reduced since 1980. Policy during the remainder of the Reagan Administration will be able to concentrate on how to keep the expansion going, a relatively easy chore compared with the earlier problem of how to reverse the economy's direction.

The rest of this chapter presents data on the principal measures of economic performance. To give a historical perspective, most of the tables include data for 1986, 1976, 1966, and 1956, which happen to be expansionary years a decade apart. Data are also presented for 1980, President Carter's last full year in office.

INFLATION

The Republican Administration has successfully brought down inflation. The rate of inflation increased steadily during the late 1970s, and in 1980 the Consumer Price Index increased by 13.5 percent. By 1982, inflation had fallen to 6.1 percent. During the past four years it has averaged 3.1 percent, and this year inflation will probably be under 3.0 percent. This year declining oil prices have contributed to price stability, but even before that effect became significant inflation had subsided to well under 4 percent. During 1986, non-energy components of the CPI have increased at an annual rate of around 3 percent. (See Table III.1.)

INTEREST RATES

Sky-high interest rates were one of the most worrisome features of the later Carter years. In late 1980, the prime rate charged by banks topped 20 percent. At one point the Treasury had to pay more than 15 percent on 3-month T-bills. Mortgage interest rates were in the high teens.

Interest rates are closely linked to expected inflation; if lenders think that inflation will erode the value of money, they will demand high interest rates from borrowers. Thus, reducing interest rates did not require the Federal Reserve to "loosen up" the money supply. On the contrary, when it was apparent that the Administration and Fed were serious about controlling inflation, interest rates started to subside.

Currently, the prime rate is 8 percent, 3-month T-bills are below 6 percent, and mortgage interest rates have dropped below 10 percent, touching off a housing boom of near-record dimensions. (See Table III.1.)

TABLE III.1.—INFLATION AND INTEREST RATES

[Averages for the year]

Year	Consumer price index percent change from previous years	Interest rates, 3-month Treasury bills, new issues
1986	[1] 2.1	[2] 5.8
1985	3.6	7.48
1980	13.5	11.51
1976	5.8	4.99
1966	2.9	4.88
1956	1.5	2.66

[1] Forecast for 1986 by Blue Chip Economic Indicators.
[2] July.

EMPLOYMENT

The unemployment rate has hovered at about 7 percent in recent months after hitting a cyclical low of 6.6 percent in January 1986. These figures are great improvements over those recorded during the 1982 recession, when unemployment exceeded 10 percent. Still, it is troublesome that the unemployment rate at cyclical peaks seems to have trended upward since the 1960s.

The economy has created jobs at a rapid rate—11 million since 1982—but the number of people in the labor force has also grown significantly. The labor force participation rate continues its slow, long-term rise, with increased participation by women accounting for all of the increase and more. The ratio of employment to population (which many consider to be the best indicator of the demand for labor) has also hit record peacetime highs in 1986. Whatever is said about "losing jobs to imports," the number of jobs in total has increased substantially, far more than in the economies of our major trading partners.

TABLE III.2.—EMPLOYMENT STATUS (CIVILIANS)

Year	Employment (millions)	Unemployment rate	Labor force participation rate	Employment population ratio
1986 (June)	109.7	7.1	65.4	60.8
1985	107.2	7.2	64.8	60.1
1980	99.3	7.1	63.8	59.2
1976	88.8	7.7	61.6	56.8
1966	72.9	3.8	59.2	56.9
1956	63.8	4.1	60.0	57.5

Source: Bureau of Labor Stastics.

Manufacturing

Manufacturing output in 1985 was 23 percent higher than in 1982, after adjusting for price changes. Some have asserted that the United States is "deindustrializing," but the following figures refute this claim:

TABLE III.3.—MANUFACTURING OUTPUT AS A PERCENT OF GROSS NATIONAL PRODUCT

[1982 dollars]

Year	Manufacturing as a percent of GNP
1986 (estimated)	22.0
1985	21.9
1980	20.9
1976	21.2
1966	22.5
1956	21.7

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

Manufacturing's share of output has been virtually constant for 30 years or more. It is remarkable that it has risen slightly when U.S. manufacturing has faced such stiff foreign competition.

Manufacturing employment is now 19.2 percent of total employment, a figure that has gradually declined for many years. Productivity improvements and the relatively growing demand for services of many kinds are responsible for this trend, which is characteristic of all advanced economics. Further, some blue-collar jobs have been contracted out to firms designated as non-manufacturing; this statistical artifact is responsible for some of the measured decline in manufacturing jobs.

Agriculture

The agriculture sector has experienced extremely severe problems in recent years. These problems involve farm prices, income credit, and surpluses. But as Table III.4 shows, the basic structure of agricultural production remains sound, as output and productivity have continued their long-term growth.

TABLE III.4.—AGRICULTURAL OUTPUT AND PRODUCTIVITY INDEXES

[1977=100]

Year	Index of farm output	Crop production per acre	Farm output per unit of farm work
1985	117	118	139
1980	103	100	112
1976	97	94	94
1966	79	83	53
1956	69	64	28

Source: U.S. Department of Agriculture.

Housing

Housing construction has grown rapidly this year in response to falling interest rates; 1986 should see nearly two million housing starts.

TABLE III.5.—HOUSING STARTS

[Millions of units]

Year	New housing units started
1986 (estimated)	1.980
1985	1.736
1980	1.292
1976	1.548
1966	1.165
1956	1.325

Source: Bureau of the Census.

International Trade

The balance of merchandise trade was a negative $148.5 billion in 1985, and exports have shown no growth for several years. As we have pointed out in previous reports, much of the trade deficit arises from the budget deficit. In order to acquire dollars with which to invest in U.S. debt, the rest of the world has had to run a surplus in the trade account. Investment in our growing economy has indeed become a worldwide passion. American investors also perceived the greatest opportunities to be at home, and the outflow of investment virtually halted. Rapid U.S. economic growth and the safe-haven effect have also contributed significantly to the trade deficit, but nonetheless, the effect of the budget on the dollar, and of the dollar on the trade deficit, is widely recognized.

The effect of the trade deficit on the economy should not be exaggerated. Some have blamed the trade deficit for the loss of millions of jobs. But in fact, employment has risen by 11 million since 1982. In Europe, which has a trade surplus with the United States, employment has declined. Employment growth rates in both Japan and Canada—with whom we run our largest trade deficits—have been slower than here.

Research and Development

The U.S. economy is particularly dependent on innovation. We devote a higher portion of our gross national product to R&D than almost any other country and consequently lead in many high-tech industries. In 1985 more than $106 billion was spent on R&D, about half coming from industry, a small percentage from universities and other nonprofit institutions, and the rest from the Federal Government. Economic studies have shown that R&D, particularly that performed by industry, makes an enormous contribution to productivity growth.

During the late 1950s and through the 1960s, industrial R&D grew at a healthy rate. But in the early to mid-1970s there was an alarming slowdown. This slump has ended. As Table III.6 shows, R&D performed by industry and government have been growing faster than during any period in decades.

TABLE III.6.—NATIONAL RESEARCH AND DEVELOPMENT FUNDING BY PERFORMER

[Average annual rates of change, 1972 dollars]

Years	Industry	Federal Government	Universities	Other	Total
1982–86	7.5	8.0	5.7	9.1	7.2
1975–82	5.5	0.1	3.3	3.8	4.4
1968–75	−1.3	0.3	0.8	−.4	−.8
1960–68	4.1	6.9	13.8	9.1	5.8

Source: National Science Foundation.

According to a recent survey by McGraw-Hill, corporate spending on R&D is excepted to rise by 8.5 percent in real terms in 1986. This would be the largest gain in two decades.

Disposable Income

Perhaps the best single indicator of economic well-being is disposable income per capita, adjusted for inflation. This shows how much each person, on average, has after taxes to spend or save. (See Table III.7.) The average annual growth between 1980 and 1986 (1.8 percent) is a bit lower than the 1956–80 growth rate (2.1 percent), but it is above the 1976–80 rate of 1.5 percent.

Personal consumption expenditures per capita, which measures the amount of goods and services that people buy, follows a similar pattern. The 1980–86 annual growth rate of 2.1 percent equals the 1956–80 rate and exceeds the 1976–80 rate of 1.5 percent.

From these measures we can conclude that, by broad measures of economic welfare, the economy's performance has clearly improved during the Republican years and is close to or on its long-term growth path.

TABLE III.7.—DISPOSABLE PERSONAL INCOME AND PERSONAL CONSUMPTION EXPENDITURES PER CAPITA

[1982 prices]

Year	Disposable income per capita	Personal consumption expenditures per capita
1986	[1] $10,798	[2] $9,956
1985	10,601	9,783
1980	9,723	8,784
1976	9,175	8,272
1966	7,280	6,607
1956	5,881	5,349

[1] 1.9 percent growth assumed for 1986.
[1] 1.8 percent growth assumed for 1986.

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

The question arises as to whether these gains have been characteristic of the Nation or whether they are concentrated by region. A Joint Economic Committee analysis of real per capita personal income growth reveals, as might be expected, considerable variation from state to state. Defining "rural states" as those where nonmetropolitan populations exceed metropolitan-area populations, it is apparent that rural states have been lagging behind and have not fully participated in the growth of the 1980s. Between 1981 and 1985, per capita personal income grew at an average annual rate of 1.0 percent in rural states, versus 2.0 percent for the entire nation. But this rural growth rate is far superior to the slight *decline* in per capita personal income that occurred between 1977 and 1981.

Stock Prices

The stock market is regarded as a good leading indicator of economic activity. High share prices make it easier for firms to finance new capital goods. A healthy market raises the value of consumers' assets, thereby stimulating spending.

As Table III.8 shows, the S&P's 500 has doubled since 1980. Adjusting for inflation, stock prices in 1980 were 20 percent lower than in 1976.

TABLE III.8.—STOCK PRICES

Year	S&P's index of 500 stocks (average for year)
1986 (mid-July)	250
1985	187
1980	119
1976	102
1966	85
1956	47

IV. ECONOMIC OUTLOOK THROUGH 1987

Our outlook published in the Joint Economic Report of March 11, 1986 now appears to be somewhat optimistic in light of first-half estimates of gross national product. We said, "The Administration's forecast of 3.4 percent real GNP growth (year over year) for 1986 is quite reasonable, and even faster growth is within the realm of possibility." While a measure of uncertainty has crept into the picture, the fundamentals still appear to be strong for the balance of this year, next year, and possibly beyond:

> The decline in oil prices has kept inflation low and has provided some stimulus to the energy-using sectors. U.S. energy production has slumped, and some regions have been badly hurt by this. But the adjustment process appears to be taking place without the calamitous financial dislocation that some had feared.
>
> The dollar has now depreciated by about 30 percent with respect to the Japanese yen (less with respect to certain other key currencies, but still quite considerably), and this correction is now starting to have some effect upon our exports. Net exports will still be negative in the 1986 GNP accounts, but negative effect on GNP will be reduced this year compared with 1985.
>
> Falling interest rates are proving to be a strong stimulant. Housing, for example, is doing even better than expected, well enough to spread substantial growth to housing-related sectors.
>
> The stock market remains strong. Stock prices are a leading indicator because they add to consumers' assets and bolster the ability of firms to raise funds for investment.

The number one risk for the latter part of this year comes from upward pressures on prices. The declining dollar, as expected, has led to price increases for imported goods, particularly automobiles. If domestic producers follow the lead of importers, the effects will be revealed in the Consumer Price Index, particularly when the effects from lower energy prices have run their course.

Monetary policy, this year and next, must walk the path between the danger of inflation and financial needs of a growing economy. The need for policies to stimulate growth during the next several years is particularly acute as the Gramm-Rudman-Hollings process continues. Growth-dampening policies, such as a tax increase, would result in higher-than-forecast deficits. Never has an economic expansion been lengthened, strengthened, or broadened by a tax increase.

The expansion is expected to continue through 1987, with growth somewhere between 3 and 4 percent. This is consistent with the latest survey of the Blue Chip forecasters, the average of which sees 1987 growth of 3.5 percent.

How will economic policy affect growth this year and next? Aside from the usual considerations of monetary and fiscal policy, we believe that a major problem is the uncertainty resulting from doubts over when and how tax reform and the budget situation will be resolved. Tax reform began its current cycle in late 1984, when the President introduced his tax-reform plan. Since then, we have had "Treasury II," a much different House bill, and two main variations—different still—considered on the Senate side. Along the way, uncertainties about the likely treatment of tax exempt bonds, capital gains, depreciation, and business investment in general have caused significant reluctance by investors to make long-term commitments.

In our annual report, we said that U.S. economic policy has for some time been a major source of economic uncertainty and has accordingly reduced economic growth. We continue to stress the importance of acting with all deliberate speed on tax reform and then leaving the tax code alone for several years at least. On the budget side, we urge that Gramm-Rudman-Hollings targets be achieved at a steady pace between now and 1991.

V. POLICIES FOR LONG-TERM ECONOMIC GROWTH

The late 1970s provide ample and painful evidence of the economic harm caused by instability. Manipulating "policy instruments" was the order of the day. These attempts to "fine tune" the economy only complicated the already difficult process of private sector planning. Ceaseless tinkering with monetary and fiscal policies, particularly the tax code, introduces uncertainties that create havoc in financial markets and anxiety among industries and individuals. Repeating this policy in the future will only lead to the same dire consequences—inflation, high interest rates, declining investment and productivity, and the resulting deterioration in incomes and living standards.

The key to sustained, long-term growth is simple in concept but difficult in execution: a stable, predictable, competitive-market policy founded on proven economic principles. History demonstrates that all else ultimately is doomed to fall short of our desires. The temptation to stray from fundamentals is alluring because it is human nature to want more than is obtainable. If the 1970s demonstrated anything, it was that there are limits on what government can do as an economic motivator, distributor, or planner. The logical conclusion, then, is that consistent and predictable Federal policies that lay the foundation for long-term economic growth are the best government can do.

We therefore recommend that the policy directions established during the Reagan Administration be pursued into the future. Specifically, we believe the following policies assure a strengthened, broadened, and lengthened economic expansion:

Return the budget to balance gradually and steadily, and without tax increases. In addition, Congress should consider granting a line-item veto authority to the President to be exercised on appropriation bills, perhaps on a temporary or limited trial basis. The experience of the chief executives in the 43 states that possess this spending control authority indicates that it could prove to be a significant asset in the effort to reduce Federal spending.

Avoid sudden shifts in money-supply growth and an increase in interest rates; maintain the value of the dollar both at home and abroad.

Enact tax policies that enhance capital formation and create incentives to work.

Strengthen trading policies that improve the world's trading system and America's role in world markets.

Eliminate Federal regulations that hamper growth or merely redistribute regulatory rent.

Promote government policies that foster individual innovation and initiative, and that augment productivity.

Stable, predictable Federal policies dedicated to open and competitive markets fortify leadership and confidence. America's vitality springs from our deep-rooted and well-founded principles: open, competitive markets, individual initiative, incentives to excel, and rewards for achievement. Advancing those virtues is the duty of government.

DISSENTING VIEWS OF REPRESENTATIVE OLYMPIA J. SNOWE

I find that I am in disagreement with specific regard to conclusions in the midyear report on our Nation's trade outlook. The picture is substantially different for the many workers in Maine and other states who have lost their jobs due to the U.S. Government's inaction on and inattention to trade crises. The workers in many of this country's import-sensitive manufacturing occupations eye the future with a great deal more apprehension and concern than emerges in the midyear report. I share these concerns.

The very fact that the trade deficit is in the range of $150 billion when it was below $30 billion only several years ago should indicate to U.S. policymakers that the tide is going out for U.S. industries. Unless measures are taken to respond to this modern international trade challenge, it is unlikely that we will see a sudden and dramatic return to prosperity.

Efforts underway this year by Congress to pass comprehensive trade reform legislation are in direct response to what the Nation's workers have been trying to tell the Federal Government for several years now: there is a strong need to enforce our Nation's trade laws and to strengthen these laws to improve the capacity of our response.

The footwear industry's situation is a prime example where a combination of policies of other nations, and purposeful neglect by ours, has caused the near demise of a U.S. industry. Since orderly marketing agreements were allowed to expire in 1981, footwear imports have soared, and have increased their market share by over 25 percent each year. As a result, we now have an astounding 80 percent import penetration, while foreign markets remain substantially closed to U.S. products.

For several years, the domestic footwear industry adhered religiously to the rules in pursuit of trade relief under Section 201 of the Trade Act. In September 1985, the President rejected the temporary import quota system recommended to him by the International Trade Commission (ITC). Having worked through the established administrative relief process, and having unequivocally proven the case for temporary trade relief, the decision to turn down the trade case came as a serious blow to the Nation's footwear industry. Unfortunately, this industry is not alone in its trade law woes.

Lack of an evenhanded national trade policy has helped to produce considerable damage in Maine. Our most traditional industries, including shoes, lumber, textile and apparel, fishing, and potato farming, are being crippled by surging imports and unfair foreign trade practices, including government subsidies. As a result, thousands of workers have lost their jobs, and hundreds of firms have closed their doors—all because our trade laws are not tailored in any reasonable way, or administered in any reasonable way, to keep our businesses competitive and our workers on the job.

In the past 10 years alone, one-third of the workers in Maine's textile and apparel business have lost their jobs as a result of mill closings. In 1985, the shoe industry suffered the loss of over 4,000 jobs, and over 30 shoe companies closed their doors. Maine's potato industry lost over $100 million and 10 percent of its family farmers because of Canadian Federal and Provincial Government assistance programs which subsidize their imports into the United States. The lumber and fishing industries face similar situations with Canada, and the effect on business has been equally gloomy.

What, then, are the policy implications of the situation in Maine and similar conditions around the country?

The views expressed in the report cite the major cause of the "coming reversal" of our trade deficit as the devaluation of the U.S. dollar. That, however, ignores several factors. First, the extensive damage incurred in the footwear and textile industries, for example, preceded the substantial increase in the value of the dollar in the mid-1980s—they coincided instead with the lifting or scaling back of import restraints on foreign products.

Second, this massive influx of products into the United States reflects a deliberate attempt by other governments to gain substantial market share in the United States, e.g., Canada's broad and complex subsidy programs for potatoes. In this effort, the rate of exchange is a tool of gaining market share, but by no means is the only one available. Simply stated, there is no indication that devaluation of the dollar will in any way hinder other governments from continuing to develop unfair trade practices to take advantage of our nonpolicy on trade.

Finally, we are left with the question of how to encourage other governments to reduce unfair trade practices, be they direct or indirect subsidies or trade barriers. Clearly, unilateral adherence to "free" trade policies has not yielded any positive results. When considering the question of a trade war, the United States is not currently dealing from a position of strength. We offer no defense. By passing a trade reform bill which provides for rigorous enforcement of our current laws, and toughening lax procedures, our trading partners will finally have a genuine incentive to phase out their unfair practices.

Only then will the import-battered industries of this Nation have the basic opportunity they seek: to compete head-to-head with foreign industries, absent the interference of foreign governments. In the harsh realities of the current international marketplace, strong measures in the United States are necessary before we meet this goal.

O