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THE 1990
JOINT ECONOMIC REPORT

REPORT

OF THE

JOINT ECONOMIC COMMITTEE
CONGRESS OF THE UNITED STATES

ON THE

1990 ECONOMIC REPORT
OF THE PRESIDENT

TOGETHER WITH

MAJORITY, MINORITY, AND ADDITIONAL VIEWS

May 7, 1990.—Committed to the Committee of the Whole House on the State of the Union and ordered to be printed

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LETTER OF TRANSMITTAL

May 7, 1990

Honorable Thomas S. Foley
Speaker of the House
U.S. House of Representatives
Washington, D.C. 20515

Dear Mr. Speaker:

Pursuant to the requirements of the Employment Act of 1946, as amended, I hereby transmit *The 1990 Joint Economic Report*. The analyses and conclusions of this *Report* are to assist the several Committees of the Congress and its Members as they deal with economic issues and legislation pertaining thereto.

Sincerely,

Lee H. Hamilton
Chairman

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THE 1990 JOINT ECONOMIC REPORT ON THE 1990 ECONOMIC REPORT OF THE PRESIDENT

May 7, 1990.—Committed to the Committee of the Whole House on the State of the Union and ordered to be printed

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

REPORT

together with

MAJORITY, MINORITY, AND ADDITIONAL VIEWS

INTRODUCTION AND SUMMARY

Over the past year, the world has shifted toward democracy and free market economies to a degree beyond any expectations. This change offers the hope of peace and prosperity for all nations. It is also a testament to the success of the political and economic systems of the United States and other Western democracies. The Members of the Joint Economic Committee are united, not only in their belief in free political systems, but also in their commitment to free market economies. And while we may disagree on the merits of individual parts of our economic system and of others, we do agree that there is a core of the free market system that allows and encourages the dynamism and prosperity that we all seek. We must protect and nurture the economic system that has won such increased allegiance over the past year.

We also recognize that this success confronts us with numerous challenges. The East Bloc countries and the newly democratizing states of Latin America will face intense economic pressures in the months and years ahead. Now-patient peoples may become disillusioned if they do not make visible progress toward the standards of living that they have observed in the West. The United States has an interest in the development of successful democracies and free markets around the world. To advance that interest requires international leadership. It also requires investment; and so our economy must grow not only to increase our own standards of living, but also to nurture peace, freedom, and prosperity elsewhere.

While the Members of this Committee naturally have many different views, we recognize the following challenges before the Nation:

- The rate of growth of our living standards has accelerated, but is still less than it was in the 1950s and 1960s. Growth has been erratic over decades and even centuries, but there are some things that we could do to make growth somewhat more rapid. We agree that productivity growth is essential to increase our future living standards.

- The Nation is losing valuable human resources through unemployment, and workers who are not adequately educated and trained. It is also clear that there are people who are out of the labor force who must be drawn in, for fairness and because it is important to growth. That will require real effort.

- While inflation is down from recent peaks, it is still above the level that inspired wage and price controls less than 20 years ago. Controlling inflation is a priority and a challenge.

- Relative U.S. influence in the world economy is less than before; after recovery from a world war, the increasing equality of nations and peoples is neither surprising nor harmful, though we have made mistakes that have sped the narrowing of our lead. We recognize this challenge to our competitive position. Looking forward, we argue that the Nation needs to invest more, to save to finance more of its own investment, and to reduce the federal budget deficit. Fair and open trade is essential for meeting this challenge, and exchange rate intervention is not a substitute.

- Too many Americans are poor, even though we have made some progress. The problem is multidimensional, and will take time and effort.

- Despite expanding attempts at cost control by government and private insurers, health care costs continue to grow rapidly, absorbing our resources. Affordability of care is crucial to fairness and the health of workers and their families.

- Our policy toward the environment must be strengthened to reduce the emissions of toxics and pollutants in the most efficient way possible. Market mechanisms are preferred, and benefits must be weighed against total costs.

- To capitalize on the tangible benefits of the reduction in world tensions, we must reshape our defense forces expeditiously but systematically.

II

TO INCREASE THE RATE OF GROWTH IN OUR STANDARD OF LIVING

The American standard of living has not grown as rapidly since 1973 as it did from 1948 to 1973. To be sure, the economy experienced two serious recessions after 1973, which depressed capital formation and long-term income growth. We have done better in the 1980s than we did in the 1970s, but we have not yet equalled the growth rates we achieved in the earlier post-World War II period. From 1948 to 1973, for example, compensation for an hour of work approximately doubled; 16 years later, it is 15 percent higher than it was in 1973. If we can raise the rate of growth of compensation to 2.0 percent per year, we can see our standard of living double every 35 years; to 3.0 percent, every 23 years. Industrial performance is determined primarily by the private sector, but government can foster an increase in the standard of living by avoiding policy mistakes that slow economic growth, saving and investment, and by making prudent investments in research, education, and the Nation's physical infrastructure.

TRENDS IN PRODUCTIVITY AND INCOME

Productivity growth is the key to a rising standard of living. Growth in the labor force or hours worked do little by themselves to raise our standard of living; more is produced but more of us have to work longer to produce it. Growth in productivity, by contrast, results in more output for the same amount of effort. Over the long term, increases in compensation tend to track increases in productivity, although compensation rose faster than productivity in the 1970s and productivity rose faster than compensation in the 1980s. Direct measures of our standard of living, such as per capita GNP and median family income, can diverge from productivity temporarily because of changes in the age and family structure of the population as well as changes in hourly compensation. Nevertheless, Table 1 shows that there was a slowdown in the rate of growth of productivity and various measures of our standard of living after 1973 and growth continues to be slower than it was from 1948 to 1973.

Growth in manufacturing productivity was as strong in the 1980s as it was in the 1960s. In other words, slower overall productivity growth is due to slower growth in measured non-manufacturing (largely service-sector) productivity growth and faster growth in service-sector jobs. Service-sector productivity is harder to measure than manufacturing productivity, and we devote less effort to such measurement. For example, government services output is calculated as the cost of labor inputs, which by definition will show no productivity growth. These measurement issues raise the possibility that our productivity statistics fail to capture quality improvements in service-sector output and hence understate true productivity growth. Another possibility, however, is that manufacturing today incorporates many productivity-enhancing activities that used to be separate service-sector activities (more use of in-house computing, for example), while contracting out other services in which productivity is increasing more slowly. If so, we may be attributing too much productivity growth to manufacturing and too little to services, while still measuring overall productivity growth relatively accurately.

Table 1
Average Annual Growth in Productivity and Measures of the Standard of Living

Period	Output Per Hour (Business)	Output Per Hour (Manuf.)	Real Compensation Per Hour (Business)	GNP Per Capita	Real Disposable Income Per Capita	Real Mean Family Income
1948-73	3.0	2.9	3.2	2.2	2.4	3.0
1973-89 [a]	1.1	2.6	0.8	1.6	1.6	0.8
1948-60	3.1	2.5	3.5	0.7	1.6	2.7
1960-73	2.9	3.3	3.0	3.6	3.2	3.2
1973-79	0.8	1.6	1.3	1.5	1.4	0.7
1979-89	1.4	3.3	0.5	1.6	1.7	0.9
1982-89 [a]	1.9	4.0	0.7	2.9	2.7	2.2

Sources: Bureau of Labor Statistics; National Income and Product Accounts; Bureau of the Census.
Note: Inflation adjustments are made using the CPI-XI.
a. 1988 for mean family income.

There is much that economists do not know about the determinants of productivity growth, but one thing they do know is that productivity increases when we invest in new capital to equip our workers with more and better factories, machines, and technology. Although investment appears to have grown about as fast since 1973 as before, this pace proved inadequate to maintain past rates of growth in productivity, for two reasons. First, the labor force grew faster after 1973, especially in the 1970s; as a result, growth in capital per worker slowed. Moreover, much of this growth in the labor force reflected entry by younger and less experienced workers. Second, and largely inexplicably, the contributions to productivity of factors other than capital investment fell sharply in the 1970s and only partially recovered in the 1980s. In the face of faster growth in the labor force and the unexplained lower growth in "residual" (that is, not-directly-attributable-to-capital-formation) productivity, we would have had to increase our pace of capital formation well above historical norms to maintain past rates of growth of labor productivity, wages, and incomes -- and we did not.

Increasing national saving and investment can make an important contribution to raising our standard of living, but increases in productivity from other sources may be even more important. For example, a rise in investment equal to 1.0 percent of GNP would add about 0.2 percentage points to our growth rate. In contrast, closing the gap between the residual productivity growth experienced in the 1948-73 period and the residual productivity growth experienced in the 1980s would add 1.4 points to our growth rate. We would have to double net investment to achieve a similar result. Of course, there are myriad contributors to residual productivity growth, no single one of which seems to be as important as investment. Moreover, even small increases in investment can improve our standard of living.

CAN WE INCREASE PRODUCTIVITY FASTER?

Industrial performance is determined primarily by the private sector, but government can foster productivity growth through macroeconomic policy, education, technology, and infrastructure.

Macroeconomic Policy

In recent years, private investment and the budget deficit have exceeded private saving. As a result, a share of our domestic investment has been financed by the savings of foreigners rather than by our own saving. The United States has benefitted from this foreign-financed investment, but the benefits would have been greater if we had financed an equivalent amount of investment with our own saving, and some would argue that U.S. monetary policy would have been less constrained by the need to attract and retain investment from abroad. If we can boost domestic saving and lower interest rates and the cost of capital, the United States should continue to attract foreign investment. But with greater national saving and more domestically financed investment, our overall investment rate will be higher, contributing to economic growth.

In looking for ways to increase national saving and investment, we need to be wary of easy answers. Reducing the budget deficit and increasing incentives for private saving and investment are both important. But proposals to reduce the budget deficit that impose serious disincentives for private saving and investment, or that seriously impair productive federal investment in education and infrastructure, are self-defeating in terms of economic growth. Similarly, proposals to increase incentives for private saving and investment that add to the budget deficit can actually hurt growth if they increase the drain on saving through the budget deficit by more than they increase saving through the incentives they provide. Our challenge is to pursue prudent macroeconomic policies that reduce the budget deficit and allow the Fed to lower interest rates without fear of rising inflation. This will require prudent tax policies that meet our revenue requirements with minimal distortions to saving and investment decisions.

Education

Just as there are no easy answers for boosting saving and investment, there are no easy answers for boosting productivity from other sources. An educated and well-trained labor force is one of the most important ingredients in the growth process, and critical failures in the U.S. education system are apparent. Nevertheless, experts disagree about the relative importance of different ingredients in the cure: money, curriculum, accountability, community commitment, more classroom hours per year, and parental involvement and choice among schools.

The United States continues to enjoy notable success in some areas of education. U.S. colleges and universities, for example, are the envy of the world. But the litany of our failures at lower levels is familiar: One-fourth of all elementary and high school students in the United States drops out; among blacks, the dropout rate is 40 percent, and among Hispanics, over 50 percent. Some 13 percent of 17-year-old Americans cannot read, write, or add and subtract. An additional 17 to 21 million adults cannot read, and millions of others have skills so rudimentary as to limit their productivity in the workplace. The problem of too many workers without the skills to succeed in today's workplace is serious now, but it will get worse in the future as many new jobs come increasingly to demand greater skills; and more than half of all new entrants to the labor force are expected to come from the ranks of immigrants and minorities, the very groups that today are failing to get those skills.

Nor are the education and skill deficiencies of the workforce being adequately addressed by American companies. Some large corporations invest heavily in worker training, but most rely chiefly on the schools to supply work skills. By contrast, Japanese and West German firms use on-the-job training to develop general as well as specialized skills. It is understandable that U.S. firms are reluctant to invest in job-specific skills when the high mobility of American labor means that workers may take these skills to other firms. Yet, international comparisons suggest that countries that rely also on company-based training enjoy stronger productivity performance than countries that rely more on school-based training. As with saving incentives, the challenge is to find ways of encouraging additional productive training without subsidizing training that would take place anyway.

Infrastructure

Sound public investment has a significant role to play in the growth process, but pork-barrel projects masquerading as public investment are a drag on growth. Public investment has declined over the period of the productivity slowdown, although it is probably not the major cause. Gross public works investment has dropped from 2 percent of GNP to 1 percent of GNP in the past three decades. Although some inefficient expenditures may have been eliminated, some maintenance of bridges and highways has also been deferred, and this hurts productivity. The Federal Highway Administration, for example, estimates that truck costs shoot up by 6.3 cents a mile when road conditions drop from "good" to "fair." A shift in spending in favor of sound infrastructure investment appears to offer a good bet for boosting productivity and growth. At issue is the appropriate allocation of such investment among levels of government and the private sector.

Technology

The United States has been the world leader in science-based technological breakthroughs since the end of World War II, in some measure because of past federal policy emphasizing support for basic science and mission-oriented (primarily defense) technology development. But as industry moves along the learning curve, international competition quickly comes down to engineering and manufacturing, where Japanese and West German firms excel and U.S. firms often lag.

The existing U.S. research system has enormous strengths, including an unparalleled university research platform, a large pool of scientific talent, and a flexible and efficient government structure for funding leading-edge scientific research. The answer to our competitive problems is not to divert resources from science and thereby risk losing our longstanding advantage. But we must adapt our approach to the emergence of new competitors with strengths different from ours.

First, we should consider supporting non-proprietary research in civilian engineering. As the former chief scientist of IBM argued, the appropriate

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debate over government investment in R&D should be framed as generic versus appropriable research, not as science versus engineering. In general, federal support is more likely to be successful when it aims for broadly applicable results rather than targeting specific industries or firms. To avoid merely substituting public for private dollars in engineering research, we might follow the criteria that the National Science Foundation follows for science; namely, research that is timely; has high intellectual value, application potential, or both; and is unlikely to be funded by industry. Second, we need to consider ways of promoting the diffusion and adoption of existing scientific and technological knowledge, not just the creation of new knowledge. Finally, in funding R&D, we should take advantage of recent opportunities to shift our spending priorities for federally funded research away from defense applications with little commercial potential toward more generic research and technology development.

CONCLUSIONS

The United States needs more saving and investment and greater productivity growth if we are to raise our standard of living faster than we have over the past two decades. There are no easy ways of meeting this challenge. But sound macroeconomic and tax policies that lower interest rates, the cost of capital, and the drain on saving from the federal budget deficit; and adequate support for education, infrastructure, and the development of new technologies are important areas where the federal government can play a constructive role. We cannot allow ourselves to be paralyzed by the current budget situation; throwing money after problems is not a viable policy, but our budget situation should not preclude the adoption of worthwhile policies.

III

TO MAXIMIZE EMPLOYMENT

Employment provides the basic source of income security for the vast majority of our population. An obvious objective of economic policy is to maximize employment opportunities. We recognize, however, that some minimum amount of unemployment is caused at any time by those who have just entered the labor force and are seeking their first jobs; those who have quit inappropriate jobs and are seeking better ones; and those who have been laid off. In good times, the number of job vacancies in growing firms and sectors will roughly match the number of job seekers. At such times, unemployment reflects the time required to link jobs and job seekers, and the seriousness of mismatches between workers' characteristics and employers' needs. Of course, linking workers to jobs may be difficult at best, or impossible at worst, if workers do not have the relevant education and skills, if labor taxes inhibit hiring, or if workers and employers are not in the same geographic location. Unemployment above the minimum amount caused by these factors reflects inadequate demand, which may reflect mistakes in macroeconomic policy.

In the opinion of some economists, these supply and demand factors affect the observed prices (wages) in the labor market, as in any other market. When there are lots of goods on the shelf waiting to be bought, or many people looking for work, prices or wages tend to be lowered; but when inventories are lean or unemployment low, prices or wages tend to rise. Of course, labor markets are special, not only because unemployment imposes very high costs, but also because labor costs account for about 70 percent of the total costs of production economy-wide. Consequently, when labor costs rise, producers try to pass on these higher costs in their prices. One key to limiting such pressures is rapid growth of productivity; if higher wages are matched by higher output per hour, prices can be stable. When wage increases exceed productivity increases, however, prices are pushed up.

Structural improvements in the economy hold the hope of further sustainable declines in unemployment. Such improvements have gained in importance as the economy has approached its current "full employment" level. Measures needed to work toward further declines in unemployment include:

- Significantly increase the quality of labor available. This will require increases in the quality of general education and the training and skills of our workforce, so that workers can adapt to changing job opportunities presented by rapidly evolving technological developments and world markets. Spending on general primary and secondary education should be increased; the availability of skilled teachers in crucial fields such as mathematics and science is not adequate, and cannot be increased without shifting funds to this purpose. Special emphasis must be given, for both economic and human reasons, to our "discouraged workers" and the "structurally unemployed."

- Maintain competitive markets. This means avoiding barriers that would cut the U.S. economy off from fair and healthy world competition. It also means avoiding inefficient regulations, while strengthening those effective regulations that limit costs to society.

- Improve the quality and dissemination of information about the likely trends in demands for labor skills and professional training, to speed up the matching of workers and needed skills. The quality and availability of information about the geographical location of job opportunities and of existing labor pools might also be improved.

CONTROLLING INFLATION AND ITS COSTS

Inflation can impose serious costs -- by distorting economic behavior, and by causing seemingly random redistributions of income. Slowing such inflations in the past has required significant losses of economic growth and output.

We agree that lower inflation is desirable, and once low and stable inflation is achieved, the best efforts of the Federal Reserve should be applied to maintain it. We disagree, however, about the measures that might be required to lower the 4.5 percent rate of inflation of the past several years, and what the costs might be; and about the precise policies and procedures that would best hold inflation down over the long run. Some argue that an explicit goal of price stability with monetary tightening when indicators get out of line could stop overall inflation in its tracks. Others respond that inflation would not slow until individual sellers of products and labor experience softness in markets and the pain of some unemployment. Despite this disagreement, we concur that improving the information upon which buyers and sellers form their expectations of prices can help to ameliorate inflation. Also, measures to minimize individual commodity price shocks should be evaluated, because sharp movements in individual prices can confuse the public about the prospects for continuing changes in the overall price level.

The overall inflation rate is an average of changes of prices in the economy. Within that average are differing rates of change of prices for specific purchases and wages. There is some evidence that the variation among individual prices and wages is wider at higher rates of inflation; and consumers and producers have to cope with individual prices and wages. At higher inflation rates, the likelihood of depreciation of the dollar may be increased as well, because the U.S. inflation rate is more likely to exceed rates abroad. Thus, higher inflation involves risks that tend to be reflected in larger risk premiums in interest rates, raising the real cost of credit and imposing a drain on the whole economy.

Finally, the overall rate of inflation may be more changeable when its average level is higher. Sudden acceleration is more damaging than moderate and stable rates of inflation. When inflation picks up or slows in an unpredictable fashion, many parties to contracts are hurt. The losers from an increase in inflation include workers whose wages adjust more slowly than prices;

investors and lenders at fixed rates of interest; and sellers with fixed-price contracts. Even though there are winners as well as losers in these situations, the capriciousness of the redistribution of real income and wealth is unfair. The prospect or reality of rampant inflation draws large amounts of resources and effort into minimizing holdings of money balances and into speculative activities in collectibles, inventories, and real estate; business investment decisions are biased by the interaction of inflation with some parts of the tax system.

While we might be driven by inflation's costs to try to exorcise it completely, absolute stability in all measured price indexes is unlikely. Our statistics will usually measure some amount of inflation, if only because demand for products shifts from one industry to another in a healthy market economy, and the strengthening demand shows through more strongly in rising prices. Also, the nature of goods and services changes over time, and quality adjustments in the inflation statistics may not be adequate. Although these phenomena mean that zero measured inflation is not an appropriate quantitative target, inflation from these sources is likely to be fairly slight most of the time.

The experience of the last two decades has generated a broad consensus, however, that the costs of rapid, accelerating inflation, and of reducing that inflation, are large. It follows that monetary policy should be chosen to control inflation. There are differences over how to judge whether inflation is out of line, and perhaps more important, how to prevent inflation from accelerating. Those who believe that inflation is almost exclusively a monetary phenomenon focus on auction market prices or the money supply to guide monetary policy, and believe that signs of inflation threats in the real economy (through consumer prices, industrial capacity utilization, employment) show up too late. Other analysts who assign a greater role for generating inflation to economic shocks (weather-related losses of crops, actions by foreign cartels, government-mandated increases in user charges and payroll taxes, or changes in import prices owing to declines in the dollar) or other developments in the real economy (tightening of particular markets) follow closely a wide array of real economic indicators as well.

This same distinction plays a role in the articulation of the Federal Reserve's commitment to maintain price stability. Those who believe that the money supply, auction market prices and interest rate reactions give a relatively complete and accurate picture of the prospects for inflation would have the Fed announce the specific actions that it would take once particular indicators move out of bounds. Those who believe that economic shocks (in both financial and real sectors) can distort monetary or real indicators temporarily would hesitate to make such a specific commitment, lest their hands be forced by some transient development.

Because inflation entails personal and social risks, a lower rate of inflation is preferred and the likelihood of unpredictable accelerations of prices should be minimized. The fundamental line of defense, of course, is the Nation's monetary authority, the Federal Reserve. The more consistent and demonstrable the Fed's vigilance, the easier the job is likely to be, because the public will then make its wage and price decisions on the basis of expectations of relatively stable prices. To meet this challenge, the Federal Reserve should frequently clarify its objectives, operating targets, and procedures to help the public to form accurate expectations.

TO STRENGTHEN OUR POSITION IN THE WORLD ECONOMY

Although the United States continues to be the leading global economic power, events in the past decade have led some to question our ability to maintain that leadership position. Much of the issue is a matter of perception. We are the world's richest economy, but large U.S. trade deficits, a rising international debt, and stiff competition from Japan, Western Europe, and newly-industrializing countries in Asia pose challenges for economic policy. If we have the will, however, we certainly have the ability to maintain our leadership role.

TRENDS IN U.S. TRADE AND INTERNATIONAL COMPETITIVENESS

There are, of course, reasons for concern about America's position in the world economy, but the facts should be kept in perspective. In many respects, U.S. economic performance in the 1980s compares favorably with that of other industrialized countries. Nevertheless, the U.S. trade deficit continues to be large and foreign ownership of U.S. assets increased faster than U.S. claims on foreign assets between 1979 and 1989. Of course, the dominance of the United States in the world economy -- in a statistical sense -- has been falling for some time, beginning with the recovery of other industrial economics from the ravages of World War II. Immediately after the war, for example, the United States accounted for about half the GNP of market economies; by 1980, less than a third. Several different measures of the importance of U.S. exports in world trade show a similar trend. Still, the United States accounts for the same share of industrial country (OECD) output that it did in 1973, and our share of world exports is larger than any other country's.

INTERNATIONAL ECONOMIC CHALLENGES

Much of the change in the relative economic position of the United States over the past several decades has resulted from good economic performance by our trading partners rather than poor economic performance by us. Given the gap that existed between us and them at the end of World War II, it was inevitable

– indeed, desirable – that they would narrow the gap. And we have benefitted, for the most part, from the economic success of our trading partners. Goods that we import have become cheaper as a result of strong productivity growth abroad, and markets for our exports have expanded with strong income growth among our trading partners. To be sure, U.S. workers, firms, and communities can be hurt by sharp, disruptive surges of imports, and by foreign barriers to U.S. exports. On balance, however, the United States continues to have an interest in promoting strong growth in the rest of the world, coupled with the opening of world markets to freer trade and competition.

All else being equal, we have benefitted as well from international investment flows. From the end of World War II until the 1980s, the United States was a net investor in the rest of the world, as our domestic saving outpaced our domestic investment. Net earnings from that foreign investment contributed to our national income. In recent years, with large budget deficits and inadequate private savings, we were able to prevent a concomitant fall in investment by attracting foreign saving. We benefit from the additional capital formation arising from foreign investment in the United States, but some of the earnings from foreign-financed investment in the United States will flow abroad. Some economists are concerned at our reliance on foreign savings, while others favor the investment that inflows of foreign savings will allow over and above what our own savings will support. Some analysts express concern at concentrations of productive capacity for particular products that may play a role in economic or national security; on the other hand, when U.S. subsidiaries of foreign firms play by U.S. rules in U.S. markets they are hardly distinguishable from U.S. firms. Moreover, we in the United States gain to the extent that foreign firms introduce new products or innovative production methods.

Despite the advantages of international trade and investment to the United States, developments in the world economy over the past decade do pose a number of challenges. First, much of the competition that U.S. firms face is not based on unfair business practices or foreign government subsidies. Rather, standard business practices in many U.S. firms, which may have worked well enough when most of their competitors were other U.S. companies with similar business practices, do not appear to be particularly well-suited to dealing with aggressive international rivals. For example, an MIT study concluded that standard business practices in many U.S. firms fell well short of the best business practices of successful foreign and U.S. firms. Thus, U.S. business faces the challenge of responding to international competition by adopting state-of-the-art business practices and developing new ones.

Policymakers face the challenge of finding alternatives to trade barriers for cushioning economic adjustment to shocks that are probably inevitable with greater international competition. Erecting barriers to foreign competition in industries facing a surge of imports can provide relief in the short run, but studies have shown protectionism to be enormously expensive and usually unsuccessful in promoting the kinds of long-term adjustment that are necessary in a dynamic economy. In many cases, adjustment can take place with minimum disruption as part of the normal functioning of markets. In other cases, carefully targeted government programs providing worker retraining and adjustment assistance may be necessary to help workers adjust to dislocation.

By limiting our own reliance on barriers to deal with the problems of adjusting to international competition, we will be in a better position to encourage other countries to do the same. Traditionally, the United States has pursued its agenda of opening world markets through multilateral negotiations involving the General Agreement on Tariffs and Trade (GATT). We continue to have an interest in reducing trade barriers through the GATT, where we have special concerns regarding agriculture and intellectual property rights in the current round of negotiations. At the same time, we have concluded a bilateral agreement with Canada, and Europe is moving toward greater economic integration in 1992. The emergence of trading groups and trade agreements outside the GATT framework is not necessarily in conflict with the kind of open international trading order that is in our best interest (with few exceptions, Europe 1992 has avoided protectionism). But we need to be vigilant that bilateral trade agreements and the organization of trading groups are directed primarily at opening trade rather than creating protected enclaves.

Reform in Eastern Europe and the debt problems of Latin American economies pose further challenges. It is clearly in our interest to support economic reform that helps Eastern Europe through what will surely be a very difficult transition. It is equally in our interest to ameliorate the crushing economic and political burdens on the third world debtor countries. Healthy markets in Eastern Europe and Latin America represent important trade and investment opportunities for the United States, just as Western Europe did at the end of World War II when we put substantial economic resources into its revival. Resources alone may not be the answer for Eastern Europe and Latin America. However, we should not be paralyzed by our domestic budget impasse into thinking we cannot afford to provide resources for worthwhile opportunities, although an adjustment of budget priorities may be necessary. Also, private capital should always be available for creditworthy activities. Nor should we infer from other countries' trade surpluses that we should relinquish leadership on this front to them.

POLICIES TOWARD THE DOLLAR AND THE TRADE DEFICIT

The underlying value of the dollar in foreign exchange markets is based on the attractiveness of U.S. goods, and real and financial assets. If U.S. firms are successful in raising productivity relative to their international competitors and if U.S. assets are attractive relative to foreign assets, the underlying value of the dollar will strengthen; if not, it will weaken. In neither case can direct currency market intervention move the dollar away from its underlying value on a sustained basis. Intervention to calm disorderly foreign exchange markets can be justified. But it is a dangerous and potentially expensive game to try to outguess the market about the underlying value of the dollar.

In many respects, the trade deficit too is an artifact of underlying policies and economic conditions and not directly manipulable by policymakers. For example, efforts to reduce the trade deficit through direct import restrictions or export subsidies will be largely offset by appreciation of the dollar unless the United States saves more (or invests less). There are, however, several ways in which changes in policy and underlying economic conditions can lead to a reduction in the trade deficit. Least desirable would be a collapse in confidence in U.S. economic policy that resulted in a drying up of foreign savings flows to the United States. Under such circumstances, we would likely see a rise in interest rates and a collapse in investment. Nor would it be desirable to experience a severe recession, although that too would probably reduce the trade deficit. The challenge, therefore, is to boost national saving sufficiently that we can expand investment and reduce our reliance on foreign saving, so that the trade deficit improves in an orderly fashion consistent with sound underlying policies.

CONCLUSIONS

If we meet the challenges of economic growth posed earlier in this report, and if we meet the challenges of restoring our international economic strength posed here, we should maintain and strengthen our position in the world economy. If we do not meet these challenges, we may indeed slip economically and our global influence will slip accordingly.

PROTECTING THE WELL-BEING OF THE LEAST WELL OFF

Almost 32 million Americans, or about 13.1 percent of the population, had incomes below the poverty line in 1988. After remaining below 12 percent during most of the 1970s, the poverty rate trended upward starting in 1979-80, peaking at 15.2 percent in 1983. Although it has declined in each year since then, it remains too high.

Policies to combat poverty must take account of differences within the poverty population. For those who are able, policy should promote self-sufficiency through paid work. For those who truly are not capable of supporting themselves, policymakers have long recognized a social obligation to provide income support. In any case, it is important to design policies that will help poor children escape from the cycle of poverty before they become poor adults with children of their own.

BACKGROUND ON THE LOW-INCOME POPULATION

The poverty population contains many different types of people. For example, almost 40 percent of the poor are children under age 18, and one child out of every five is poor. In 1979-81, when the U.S. poverty rate for children was lower than it is now, it was the highest poverty rate for children of any major developed country.

Another 11 percent of the poor are aged 65 and over, and about 28 percent of poor household heads cite disability as the reason they are not employed. The remainder of the poverty population includes single parents, married couples with a low-earning or unemployed member, young people just starting out, and older workers, retirees or widows who have not yet reached age 65.

Despite sustained economic growth since 1982 and the lowest unemployment rate in 15 years, today's poverty rates remain high by historic standards. Further, the standard used to compute the poverty rate relies on consumption data from the mid-1950s, and is in need of an update to reflect today's needs more accurately.

These continuing high poverty rates in a period of strong overall growth are to some extent explained by the fact that although the average cash income of those in the bottom 20 percent of all families has grown almost 13 percent since 1982, it is still almost 5 percent less than it was in 1973. Many also view changes in social institutions over the last 20 years as a major factor contributing to the intractability of poverty.

Federal spending on income support programs is a smaller share of the budget today than it was in 1980, when means-tested income support programs (other than medical benefits) accounted for 5.5 percent of total outlays, compared to 4.8 percent in 1989. Real outlays in support of low-income Americans increased by 19 percent between 1980 and 1990. But most of this increase occurred in the Medicaid program and largely represented increases in medical care costs. Adjusting for both population growth and inflation, total spending in the food stamp, AFDC, and child nutrition programs fell by an average of 2 percent per year between 1981 and 1987. At issue is whether more federal spending on means-tested programs would reduce poverty.

PRINCIPLES FOR AIDING THE LOW-INCOME POPULATION

While some programs providing aid have been controversial, and, some believe, even counterproductive, certain principles for aiding the poor are widely accepted today. For example, a major goal of anti-poverty policies over the last decade has been to encourage the poor to become more self-sufficient. Work requirements in programs such as food stamps and AFDC have been strengthened, and employment and training initiatives for this population have been emphasized. Under the Family Support Act of 1988, for example, new job training programs for AFDC recipients were established, additional child care support was introduced for trainees and for workers leaving AFDC, and Medicaid benefits were extended for 12 months for those leaving AFDC for a job. The structure of AFDC benefits for the working poor, however, imposes a high implicit tax burden, at the margin, on this group.

Other child care, health and tax initiatives have also been introduced to enhance the rewards of working relative to welfare. Proposals to increase child care opportunities for low-income workers were passed by both the House and the Senate last year, and although no final bill was approved such legislation is likely to be on the agenda again this year. Similarly, the Earned Income Tax Credit (EITC) for low-income workers with children was raised substantially under the Tax Reform Act of 1986, and further increases have been proposed.

These proposals help to reward families achieving greater self-sufficiency, and to smooth the path from welfare to work. Some of the poor are truly unable to support themselves, however, even with public job assistance programs. This group includes the low-income elderly and many of the disabled. Providing support for this group has been a second major policy objective over the past several decades. Real outlays in the Supplemental Security Income (SSI) program, for example, which provides benefits to the low-income elderly and disabled, have grown by about 2.3 percent per year since 1981 after adjusting for population growth.

A third important goal of programs to help the poor is to provide opportunities for advancement and to prevent the intergenerational transmission of poverty. Some argue that long-term welfare program participation demoralizes recipients and lessens their initiative. A recent Ford Foundation report included a proposal to subject AFDC payments to definite time limits as a way of lessening welfare dependency.

Investment in the education and health of today's poor children may also lessen future dependency by helping these children to become tomorrow's productive workers. The Headstart program, which has been effective at reducing the educational disadvantages of poor children and encouraging parental involvement in their education, comes up for reauthorization in 1990. It currently serves only about 17 percent of three- to five-year old children in poor families, however, and many -- including President Bush -- have proposed expanding the program to cover a larger proportion of those eligible. Similarly, the Special Supplemental Food Program for Women, Infant, and Children (WIC) results in long-term improvements in health and nutritional status for poor children, but again fewer than half of those eligible receive benefits. The Congress has recently expanded the availability of health care for pregnant women and for infants, which could improve the health of low-income children.

Finally, sound policies to promote economic growth, including wage and employment growth for low-income workers, are also an important means of combating poverty. Despite solid GNP growth during this expansion, real compensation per hour (the inflation-adjusted value of wages, salaries and non-wage benefits) has grown relatively slowly. Faster growth in productivity and in compensation for low-income workers, in particular, would help lift their living standards as the economy grows.

THE MEDICAL CARE CHALLENGE: MAINTAINING ACCESS TO HEALTH CARE WHILE CONTAINING COSTS

Most Americans enjoy superior health care. However, the system is widely perceived to be flawed both in terms of the high cost to the Nation and the inadequacy of coverage for many individuals. It provides expensive state-of-the-art treatment for illnesses, yet often fails to deliver more basic (and perhaps more cost-effective) preventive care.

Health care expenditures in the U.S. reached a total of about $600 billion in 1989, or more than 11 percent of GNP -- among the highest in the world. By the end of the century these expenditures are projected to grow to about 15 percent of GNP. Rising health care costs impose a growing burden on taxpayers, employers paying health insurance premiums, and families with inadequate insurance coverage. Fairness and economic growth require that we achieve adequate health care for our entire population, while developing a more efficient system for providing that care.

PROBLEMS OF ACCESS

Costs and Access to Care for the Elderly

On average, the annual cost of medical care for someone aged 65 or over now exceeds $5,000, only about half covered by Medicare; Medicare outlays for FY89 totalled $85 billion. Even after payments by private insurers and Medicaid, elderly persons on average pay about $1,250 per year out of pocket for health care. As costs continue to rise, and as there are more elderly in the highest age brackets, these non-covered costs will grow and may limit access to care, particularly for those with large bills and those who need long-term care.

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Health Care Coverage for the Uninsured and for Low-Income Families

As health care costs rise, the problems of families with little or no health insurance also become more acute. About 37 million Americans under 65 have no coverage at all, although almost 90 percent of these are in families with at least one adult worker, and more than 40 percent with someone working at a full-year, full-time job. About 30 percent of the uninsured are poor, and fewer than one-fourth are in families with incomes over the median.

Even minor illnesses can cause major hardships for low-income families without adequate health insurance; many also neglect needed preventive care, such as childhood immunizations and pre-natal care. Partly for this reason, the United States has higher infant mortality than most other developed countries; lack of routine care also adds to health care costs in the long run.

Although Medicaid does provide health care to some poor families, only about half of all children below the national poverty line are covered, and some may still fail to obtain pre-natal and well-baby care because Medicaid payments for these services are relatively low. Additionally, Medicaid and the uncompensated costs of public hospitals -- the major source of emergency care for the uninsured -- are a growing drain on the resources of many state and local governments.

PRINCIPLES FOR ASSESSING HEALTH CARE APPROACHES

Controlling Costs

Reducing the general rate of cost increase is an important national goal, both for reasons of economic growth and because the rapid increase in health care costs bears particularly heavily on the uninsured and those with inadequate coverage. One means to this goal is maintaining cost consciousness among consumers. In the earlier post-World War II decades, private and government insurance moved toward comprehensive, first-dollar coverage, under which the patient and the health care provider might have no incentive to limit usage or costs. In the more recent period, in part because of the explosion of costs, the federal government (in its capacity as an insurer in Medicare) has exerted considerable leverage on the health care sector through its setting of fee schedules. Private insurers have bargained on costs as well, as they have felt increasing resistance to premium increases from employers and individual policyholders. While much of the price consciousness thus rests with government and private insurers, individuals have also reacted to premium increases by choosing plans with greater use of deductibles and copayments, and the elderly already bear a significant portion of costs under Medicare.

Both government and private insurers have sought to influence the allocation of health care dollars to achieve greater efficiency. For example, the Prospective Payment System (PPS) for hospital reimbursements under Medicare, and the parallel Medicare Physician Payment Reform for physicians' fees, were attempts to control prices and allocate resources more efficiently. These reforms, if successful, could contribute to cost reduction more generally through the influence of Medicare as the largest single actor in the health care system.

Improving Access to Care for the Uninsured and for Low-Income Families

There is a broad consensus on the severity of U.S. health care problems, but virtually none on solutions. The rapid fire adoption and then repeal of catastrophic coverage under Medicare is a graphic indication. Medicaid legislation passed last year will expand care for pregnant women and children up to age six in families with incomes up to 133 percent of poverty. At their discretion, states may further expand Medicaid to cover pregnant women and infants under age one with incomes below 185 percent of poverty. Such investments in pre-natal and infant care have been shown to result in long-term savings.

There are at least three basic directions in which the system could move, should fundamental change be judged essential. One is toward national health insurance, through combinations of new or existing public programs, and perhaps some form of private insurance participation. This option would provide the widest pooling of risk, and the widest access. A second is toward mandated employer-provided health insurance for all workers. This would reduce the number of uninsured, and government's direct costs, while increasing the cost burden of health care on at least some businesses; other businesses that now indirectly bear unreimbursed costs through their insurers might gain. A third direction would be to shift more of the responsibility to individuals by reducing or eliminating the tax exemption for employer-paid insurance premiums, and perhaps expanding the individual income tax subsidy for medical costs. This approach would increase the cost consciousness of individuals and perhaps allow risk pooling based on health rather than employment. Any of these or other fundamental changes would involve broad ramifications, and would require careful study.

THE ENVIRONMENT IN THE 1990s

A prosperous economy ought to provide us with a clean environment. Yet it often seems that the needs of the economy and those of the environment conflict. Sound environmental policy should be part of a sound economic policy, not something that competes with it. The benefits of environmental protection must be weighed against its costs.

Consumers clearly value a clean environment, but it is difficult to put a price tag on it. We have little information on what workers and consumers might pay for a cleaner environment, because private markets in which to purchase one typically don't exist. They don't exist because private interests find it difficult to charge for the benefits of a clean environment, which are inherently diffuse.

We don't know precisely what people <u>might</u> pay to reduce pollution, but we can estimate what they already <u>do</u> pay to offset its consequences. In the case of air pollution, for instance, health care costs and damage to crops, livestock and buildings amount to billions of dollars per year. Costs such as these must be weighed against the costs of reducing pollution.

There is a fairly wide consensus among economists regarding principles, but agreement often breaks down over specific environmental problems and approaches. Environmental problems are highly idiosyncratic. What works in one area may be completely inappropriate in another.

Also, government policies as well as private markets sometimes fail to balance social costs and benefits for environmental issues. The highly interdependent nature of the environment and economic systems can easily give rise to unintended policy consequences. For instance, a policy that unduly emphasizes reducing pollution from new autos or power plants will raise their prices and encourage the use of older, dirtier technology. There are five general approaches to pollution abatement.

Market-based incentives. When pollution sources are identifiable and pollutants measurable, governments should try to harness economic incentives. For instance, if fees can be assessed per unit of pollutant, those responsible for the most pollution will have the greatest financial incentive to reduce it.

Furthermore, such fees can allow polluters to reduce their emissions in the manner best suited to their particular circumstances. Auctioning off permits to release restricted amounts of pollutants can work in much the same way.

Mandated performance standards. In some cases it makes sense to mandate standards for allowable pollution. Like market-based incentives, such standards can be designed to allow polluters considerable flexibility in choosing the best technology.

Strict prohibition. Some pollutants are so hazardous or so difficult to measure that strict prohibitions make sense. Plutonium, for instance, is so deadly that we don't want any released, irrespective of the amount of money a polluter might be willing to pay for the privilege.

Mandated technologies and public production. Situations involving unique resources, natural monopolies or unusual social risks also may require more direct government policy. Most communities, for instance, rely on government itself or regulated private entities to dispose of sewage.

Information. Sometimes governments can encourage private parties to resolve environmental issues on their own just by providing better information about the nature of the problem that they face.

We believe that environmental policies should harness the power of financial self-interest wherever appropriate. As a rule, such policies emphasize flexibility of response, sliding scales rather than absolute cutoffs, and carrots as well as sticks to encourage proper incentives. In the past, environmental policy frequently has failed to exploit the power of economic incentives. However, the specialized nature of environmental problems argues that we not rely on any single approach for all situations.

THE PEACE DIVIDEND

Political liberalization in the East Bloc and the easing of Cold War tensions suggest the possibility of sizeable reductions in defense spending. We agree that the "peace dividend" will be smaller in the near term but could grow considerably, and is unlikely to cause recession. There is no consensus on how the defense savings should be used.

Real defense spending will decline by about 2 percent in FY90 but still remains almost 44 percent above its 1980 level. If real spending continued to decline at a 2 percent rate, this would put the FY95 defense budget 13 percent below its peak of two years ago.

Such cuts seem modest, especially compared to the $100 billion to $200 billion savings estimated in some early press accounts. In fact, these large projected savings are not actual cuts in current-dollar defense spending. Rather, they are the cumulative difference between a fairly flat path for current-dollar spending and earlier government projections calling for defense increases at a pace well above the rate of inflation.

The pace of international political change has been breathtaking. Even as recently as a year ago, few predicted anything like the political upheaval of 1989, and that should serve as a caution to anyone who now claims to know the future. While some recent developments (including the tensions in the Soviet Baltic Republics) raise serious uncertainties, most (including the continuing democratization of the Eastern European nations) suggest that much of the recent change is irreversible. To the extent that changing relationships in Eastern Europe have led to concrete reductions in Warsaw Pact military infrastructure, and earlier notice of troop advances, political change should lead to a reduced threat and defense needs.

Near-term defense outlay savings will be modest because mustering out soldiers, mothballing weapons and closing bases themselves cost money; because hardware ordered in the past entails current contractual costs; and because cuts in new orders of hardware tend to save little in the near term, though more later. The long-term planning that underlies modern defense makes abrupt changes in direction difficult and costly. However, the extraordinary reduction of tensions may allow large cuts in long-term commitments that will lead to sharp declines in outlays a few years down the road.

Reduced defense spending is unlikely to contribute to a recession as happened after the Vietnam, Korean and Second World Wars. Defense has a far smaller presence in the economy than in those earlier periods, accounting for about 6 percent of GNP compared to about 9 percent for the Vietnam War, 13 percent for the Korean War and about 40 percent during World War II. In addition, fiscal policy is aiming toward sizable deficit reductions in any event.

Thus, the national economic consequences probably will be fairly minor. However, some particular workers, industries and communities will feel an impact as bases are closed and plants shut down. If defense savings in a few years are as large as the rapid pace of political change suggests, local adjustments may be severe, and there will need to be creative ways to speed the conversion to nondefense jobs and products.

Despite these concerns, most economists believe that reduced defense spending ultimately will benefit the economy. Resources that would have gone into defense eventually can be devoted to investments that more directly raise our standard of living. However, analysts disagree about the best way that this should be done. Many would like to use the peace dividend to reduce the budget deficit, thereby reducing government credit demands and encouraging private investment. Others would devote the money to needed public investment in physical infrastructure and human capital. Still others suggest using the defense savings to cut taxes.

ECONOMIC POLICY AND PERFORMANCE IN THE DECADE AHEAD

INTRODUCTION AND SUMMARY

Democratic members of the Joint Economic Committee have long been concerned that the economic successes of the 1980s -- a long-lived recovery, moderate inflation and unemployment, and substantial resilience in the face of stock market and exchange-rate shocks -- have obscured serious weaknesses in economic performance and policy. These weaknesses could erode our ability to grow, compete, and provide a rising standard of living to the majority of Americans.

In these *Views*, we will focus on five major themes about economic policy in the decade past and economic performance in the decade ahead.

First, we believe that the modest economic growth of the 1980s, however welcome, has been built on a foundation of borrowed money -- an attitude of "anything goes," buy now and pay later. Large federal deficits and a wave of private borrowing have tilted national spending toward consumption and away from investment. This short-term decision making undermines our economic strength and jeopardizes our position in the world economy.

Second, we believe that our economic policies are slowly eroding our control of our own economic destiny. Large and persistent federal budget deficits constrain our ability to meet pressing public needs, while our rapid buildup of foreign debt shifts control of our exchange rates and interest rates into the hands of our foreign creditors. Our dependence on foreign sources of energy and critical technology has increased markedly.

Third, there are disturbing signs that our economy is becoming much less fair. The environment of economic mobility -- where anyone willing to work hard could achieve a decent and rising standard of living -- is much less in evidence for the average working American today. Wages have stagnated throughout the 1980s, with many new jobs paying low wages, and family incomes have grown modestly only because more family members have worked more hours. Income inequality has grown steadily -- a sharp reversal of the historic trend toward more equality during expansions -- to its highest level since we began collecting such statistics in 1947.

Many of the old channels for mobility have closed. Factory work, once a route to middle class incomes for relatively unskilled workers, has been reduced by foreign competition and domestic cost-cutting. Primary and secondary school performance is inadequate, while higher education has grown more expensive and further out of reach exactly when education is essential for income growth.

At the same time, competitive pressures are driving firms to cut labor costs. Wage givebacks, the use of "contingent workers," and reductions in corporate funding of pensions and health insurance all cut deeply into the standard of living of American workers, who, more than workers in other developed countries, must purchase retirement security, medical insurance, child care, and education out of their wages.

Fourth, many of the economic policies of the past decade have increased the potential for economic instability. The Federal Reserve is holding the economy at low growth to control inflation, and huge budget and trade deficits leave us ill-prepared should recession result. Lax supervision of financial institutions has already led to a massive failure of savings and loan institutions; and problems in the market for "junk bonds" have substantially increased the risks to commercial banks and insurance companies holding these bonds. That these weaknesses have not created a crisis is a testament to the resilience of our competitive market economy. But resilience is not an excuse for indifference to problems that can and should be corrected.

Finally, we believe that our future in an interdependent world economy depends upon our ability to craft international institutions and agreements that benefit all nations. So far, our shortsighted domestic political priorities have weakened our international leadership and our ability to negotiate relationships which will serve our long-run interests.

The Bush Administration has presented commendable analyses of our economic problems. Yet they propose only tired spending cuts, rejected by Republicans in Congresses past, and tinkering with the tax law that would barely dent our problems in the most fanciful outcome. If we accept the Administration's analyses, we need more fundamental policy changes to meet the challenge of the 1990s.

WEAK FOUNDATIONS FOR ECONOMIC GROWTH

Nobel laureate James Tobin, testifying before the Joint Economic Committee, has characterized economic performance over the past decade as a demand-side success but a supply-side failure. By this, he means (a) we have achieved high employment without excessive inflation by giving people enough spendable income to keep workers employed and factories busy meeting the demand for goods and services, but (b) we have failed to increase growth in the economy's capacity to supply goods and services. In the 1950s and 1960s, our capacity to supply goods and services (in economic terms, "potential GNP") grew at better than 3.5 percent per year. Recently, that growth has been about the same 2.5 percent per year that it was in the 1970s -- a decade that suffered from two serious oil price shocks.

The root of this supply-side failure is our macroeconomic policy. Large budget deficits, combined with extensive financial deregulation, encouraged the U.S. to expand consumption more rapidly than production, and to finance this excess consumption with debt. At the same time, anti-inflationary monetary policy kept U.S. interest rates high, discouraging domestic investment, raising the exchange value of the dollar, and harming U.S. international competitiveness. With high deficits and rising interest costs, federal spending for a broad range of needed public investments was sharply curtailed. Taken together, these policies produced an American economy in apparent good health when measured by such current indicators as the growth of employment or consumption, but with serious long-term problems when measured by such criteria as productivity, investment, and international competitiveness.

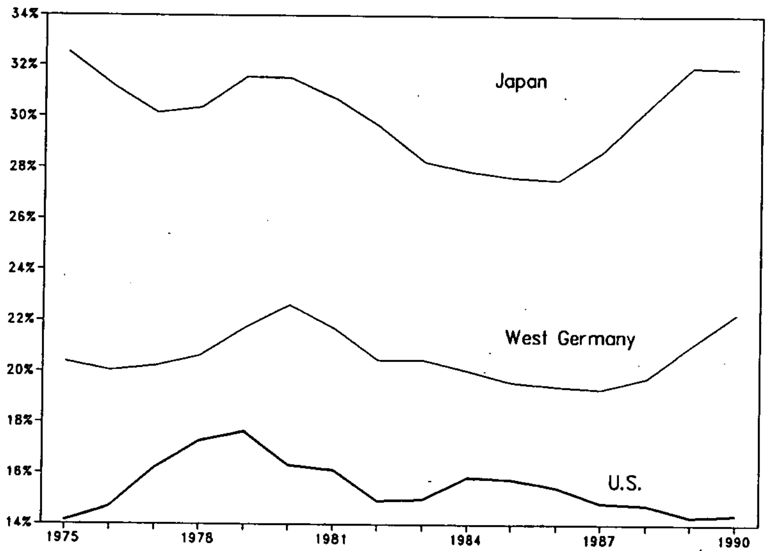
Slow Productivity Growth

Output per hour of work in the U.S. economy grew a sluggish 1.4 percent per year between 1979 and 1987 -- well below its average of 3 percent per year between 1948 and 1973. Last year, overall productivity grew a mere 0.9 percent, the lowest rate since the recession year of 1982. U.S. productivity growth has also lagged that of other major industrialized countries. Since 1980, Japanese productivity growth has outpaced that in the U.S. by 19 percent, while German growth over the period is more than 7 percent higher.

Weak Private Investment

A major cause of America's poor productivity performance is our neglect of investment at all levels of the economy. Investment -- in machines, in education, in infrastructure, in research and development -- is funds set aside today to add to our capacity to produce in the future. Poor productivity performance can be an early indicator of inadequate long-term investment. We devoted no greater share of national income to gross investment in the 1980s than we did in the oil-shocked 1970s. And as Figure 1 shows, U.S. investment performance continues to lag behind that of our major competitors.

Figure 1. Gross Fixed Investment as a Share of GNP



Source: Data Resources, Inc.

But gross investment includes replacement of old capital as well as net additions to the capital stock. Net investment, the margin over the replacement of worn out capital, tells us the rate at which we are expanding the quantity of tools and facilities needed to boost the productivity of an expanding work force; and our net investment rate is 20 percent lower than it was ten years ago.

The United States also continues to spend a far smaller percentage of its GNP on civilian R&D (1.8 percent) than West Germany or Japan (2.7 percent). A recent study by the National Science Foundation revealed that research and development spending in the private sector actually fell in real terms during 1989. Federal research and development policy has not been as effective as it could be in addressing civilian R&D needs. Nearly two-thirds of federal research support goes for defense, up from half at the start of the Reagan Administration. And DOD support for basic research as a fraction of its

Research, Developing, Testing and Evaluation (RDT&E) function is now less than half what it was in the mid-1960s.

Our private investment has been increasingly financed by foreigners, due to our shortage of domestic savings, both private (through low household savings and expanding corporate debt) and public (through the immense federal budget deficit). Furthermore, our high interest rates, caused by our shortage of savings, have twisted investment toward short-term payoffs rather than long-term strength.

Inadequate Public Investment

Public investment has also suffered during the 1980s. Outlays for infrastructure have declined from almost 2.4 percent of GNP during the late 1960s to barely 1.0 percent of GNP during the 1980s. Growth in public infrastructure has lagged behind growth in private capital and the labor force; public capital per worker peaked in the early 1970s and has been declining ever since. Public investments have lagged not only in traditional areas of infrastructure, transportation and education, but also in the new "information infrastructure" needed for an economy based on technology and information.

Statistical studies have shown a close correlation between public capital per worker and national rates of productivity growth. Such a statistical connection should not be surprising: deteriorating roads lead to increased vehicle maintenance costs, and air traffic delays waste time and slow deliveries, for example. There is a more direct connection between private sector productivity and public investment in education; unskilled workers cannot master the complex processes that characterize best-practice manufacturing techniques. Recently the Joint Economic Committee was presented with a letter signed by 327 economists, including 6 Nobel Prize winners, which stated:

> In addition to our trade and fiscal deficits, America faces a 'third deficit' -- the deficiency of public investment in our people and our economic infrastructure. This deficit will have a crippling effect on America's future competitiveness.

Human Capital Investment

There is a major dispute about the correct way to measure a nation's effort in education. The United States ranks near the bottom of industrialized countries on the share of GNP it commits to educating each pupil in the elementary and secondary grades, while ranking high in actual dollar spending per pupil. Although the per-pupil share of GNP is the better indicator of a country's priority on education, it could be argued that rich countries can achieve superior

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results spending smaller fractions of a larger GNP. Unfortunately, the evidence is that we have both a lower priority on primary and secondary education than other countries and significantly poorer educational effectiveness.

In the United States, some 20 percent of adults are functionally illiterate, while adult illiteracy is virtually unknown in Germany and Japan. American students regularly score at or near the bottom of international tests measuring mathematical ability, verbal reasoning and basic knowledge. A recent study showed that the average Japanese high school student performed better than 95 percent of U.S. high school students in mathematics. The United States each year produces about 78,000 engineers. Japan, with half the population, produces virtually the same number. In addition, over 50 percent of engineering Ph.D.s granted by U.S. institutions were earned by foreign nationals, which raises questions both about the adequacy of American secondary schools and about our ability to retain the skills learned in our educational system.

INCREASING ECONOMIC DEPENDENCE

During the 1980s, the United States steadily lost competitiveness in a broad range of industries. A combination of an overvalued dollar, slow relative productivity growth, fast relative growth in domestic demand and high domestic interest rates did enormous damage to the goods-producing sector of the economy. The decline in the dollar starting in 1985 sparked an increase in exports during 1987 and 1988 and narrowed the trade deficit in those two years. Since 1988, however, the trade deficit has stalled. Export growth has slowed markedly and the monthly trade deficit has risen.

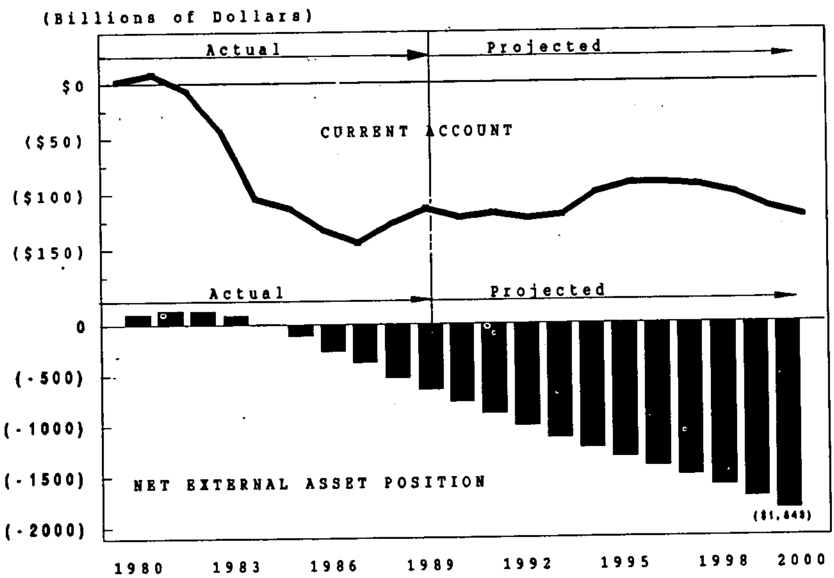
Of particular concern is our rapid loss of international market share in industries with critical technologies and high growth potential (e.g., telecommunications, semiconductors, business equipment). For example, between 1985 and 1990, our estimated share of the U.S. market for optical lithography equipment (used to etch circuit designs on semiconductors) was cut nearly in half by international competitors. Because we will run large trade deficits in many low-tech markets for the foreseeable future, we cannot restore trade balance without sizeable surpluses in these high technology sectors.

Our loss of competitiveness is one part of our loss of control over our economic future. There are three other dimensions: substantial reliance on foreign capital to finance our domestic investment; substantial reliance on foreign technological expertise; and diminished ability to respond to our own problems.

Dependence on Foreign Capital

Throughout the 1980s, the United States has consumed more than it has produced, and has borrowed from abroad to finance the difference. The current account deficit, shown in Figure 2, measures such borrowing. The top panel of Figure 2 shows the current account deficit for each year, while the bottom panel shows how each year's borrowing adds to the cumulative deficit – our total net external debt. Before the 1980s, the United States ran a rough trade balance, and had a balance of international assets rather than a debt. After the enormous trade deficits of the 1980s, however, we have accumulated an international debt which is projected to reach nearly $2 trillion by the end of the century.

Figure 2. U.S. Current Account and Net Asset Position



Source: Data Resources, Inc.

We are now dependent upon foreign capital. Without funds borrowed from abroad, our domestic interest rates would rise, cutting into our already weak investment. Even a temporary slowdown of foreign funds could create major disruptions, as in 1987 when foreign investors, concerned about U.S. economic policies, slowed their purchases of U.S. securities. This pause drove interest rates up and set the stage for the stock market crash. A similar pause in foreign lending appears to be driving up U.S. interest rates in the early part of 1990.

Dependence on Foreign Technology in Critical Areas

The United States has traditionally been at the forefront of technology, and U.S. firms have captured commanding positions in important new fields such as telecommunications, computers, biotechnology and medical technology. Unfortunately, the United States is not capturing the economic rewards of technological development. While we continue to excel in basic science, we seem to be lagging in commercialization of this science.

Despite this problem, we continue to deny to applied engineering the support we give to basic science, on the ground that support for engineering brings government too much into the productive process. The danger of this artificial distinction between science and engineering has been made clear by Lewis Branscomb, IBM's former chief scientist, who noted that "... we must also understand that science has changed the way technologies are generated and applied, and has done so in such a way as to enhance the economic value of strong science, but only provided it is coupled to strong engineering."

This erosion of our technological leadership is clearest in semiconductors, where two decades of concerted effort by foreign firms and governments have cut U.S. market share sharply. The National Advisory Committee on Semiconductors in 1989 concluded that:

> The semiconductor industry, after an era of world leadership, is now in trouble. It has lost its dominant position in the world market. This radical change has occurred in the 1980s despite the fact that American industry invented, developed, and dominated the semiconductor market for three decades.

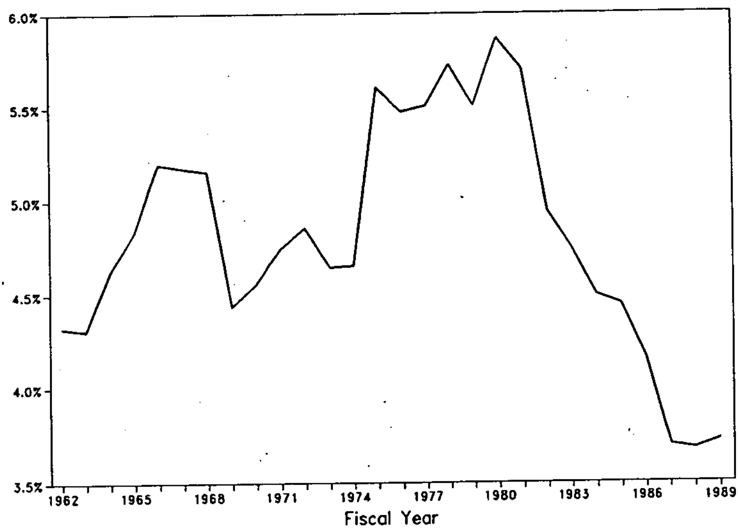
Dependence on Foreign Resources

During the 1970s, two oil shocks forced us to develop a national energy policy to reduce our dependence on foreign sources. This policy was abandoned during the 1980s, and by 1989 imports of oil were larger than U.S. domestic production. This dramatic increase in import dependence has been encouraged by declining world oil prices, but experience suggests that these trends will not continue indefinitely. Continuing energy dependence could prove a real economic vulnerability.

Domestic Dependence: Tied Hands

The most damaging legacy of the 1980s is the weakening of our public sector. The United States has many problems that could adversely affect economic performance and the quality of life: drug abuse, poor primary and secondary education, a comparative shortage of engineers, deteriorating infrastructure and a lack of public support for applied research and development are only part of the catalog. Yet the public resources to deal with these problems have declined during the 1980s.

Figure 3. Non-Defense Discretionary Spending as a Share of GNP



Source: Congressional Budget Office

Figure 3 shows the share of GNP devoted to "non-defense discretionary" spending by the federal government. This includes all programs except defense; spending on entitlements such as Social Security, Medicare, and low-income support; and interest on the national debt. This is a measure of government's effort in dealing with the problems of the U.S. economy, and in fulfilling its basic, traditional functions: building and maintaining roads and bridges, and providing for the public education and safety, for example. These are the programs that have been squeezed in the panic to reduce the runaway deficits after the policy mistakes of the early 1980s. The sharp decline of government efforts in these areas is cause for serious concern.

GROWING UNFAIRNESS

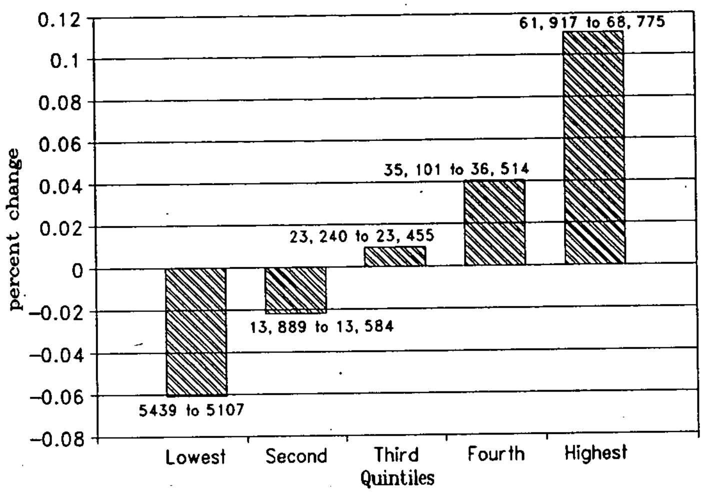
From the perspective of an ordinary worker, the performance of an economy can be measured simply. Is opportunity expanding? Can ordinary jobs and hard work provide access to the basics of a good life -- decent housing, adequate health care, a good education for your children? Are economic rewards spread broadly throughout the society? By these standards, the performance of the American economy over the past decade has been unsatisfactory.

After rising steadily at average annual rates of nearly 3 percent between 1947 and 1974, real wages essentially stopped growing after 1978. At first, the stagnation in real wages reflected a stagnation in productivity growth. But during the 1980s, when productivity partially recovered, real hourly pay remained stagnant and today stands only one percent above its 1978 level. Though small differences between productivity and pay have opened in the past, this "wedge" has never persisted for so long. Not only have wages grown more slowly during the 1980s, there has also been a steady increase in inequality of earnings among workers. The most dramatic change is the growing gap between the earnings of male college graduates and those with less education, but studies have found growing inequality within groups of workers with similar gender, age or education.

Median family income was only 6 per cent higher in 1987 than it was in 1973. Recent Census Bureau statistics show that median income for families fell in 1988 for the first time since the recession year of 1982. If family income had grown at its pre-1973 rate, the median family would now have about $12,000 more income.

Inequality in family incomes is also increasing. In 1988 (the latest year for which data are available), the richest 40 percent of all families in the United States received 68.0 percent of all family income, compared to 65.8 percent in 1979. The poorest 40 percent of all families received 15.3 percent of all family income, compared to 16.8 percent in 1979. This disparity in income shares is the largest since these statistics were inaugurated in 1947, and the increase in inequality in an economic expansion is unprecedented. Figure 4 documents the change in family income for each fifth of the population.

Figure 4. Changes in Family Income, 1979-1987 (Percent change in average income by population quintile measured in constant 1988 dollars)



Source: U.S. Department of Commerce, Bureau of the Census

According to a recent CBO report on family incomes, it is young families that have been hardest hit by the trends of the 1980s. Fifteen years ago, families headed by people under 30 earned 38 percent less than families headed by 30-to-64-year-olds; today such young families earn 58 percent less.

Finally, poor Americans have not fared well as the general economy has prospered. The official poverty rate has dropped since the 1981-82 recession, but at 13.1 percent (about 32 million people), it remains above what it was at any time in the 1970s, including recession years. Moreover, as a recent Joint Economic Committee staff study documented, nearly one American in four would be classified as poor and the poverty rate in 1988 would be higher than it was in the recession year 1982 if the methodology used to define "poverty" were updated to reflect 1980s consumption patterns.

The causes of wage stagnation and growing inequality are multiple and complex. Factors like the proliferation of single-parent and two-earner families or the labor force bulge due to the Baby Boom clearly played a role, particularly during the 1970s. However, these demographic patterns eased in the 1980s, and, if anything, ought to have produced a faster rate of income growth and declining inequality. The fundamental causes of stagnation and growing inequality appear rooted in policy decisions concerning macroeconomic policy, competitiveness, and human capital investment.

During the 1980s, high interest rates, an overvalued dollar, and increased import penetration all put pressure on firms to cut costs and shift production to lower-cost sites abroad. At the same time, changes in antitrust policy, securities policy and financial regulation all produced a wave of corporate restructurings which replaced equity with debt. These trends put downward pressure on wages, particularly for production workers, while increasing the capital costs of production. Further, competitive problems worsened both the growth and distribution of income. Traditionally, employment shifts toward higher-paid sectors of the economy during recoveries, but there was virtually no growth in high-paid sectors in the 1980s; and the resulting shift toward lower-paid sectors subtracted about a third of a percentage point from compensation growth each year.

Income stagnation and growing inequality are problems in and of themselves, but the human consequences are made worse by the inadequacy of our social welfare programs and our reliance on employment as a source of health care and other necessities. Compared with most other industrialized nations, we have no national health insurance system, much smaller public housing programs, and significantly less public support for child care and higher education. Thus, Americans rely more heavily on employment to obtain adequate medical care, housing and education. When a worker is unemployed or takes a new job with fewer benefits, he loses much more than wages, and much more than workers elsewhere in the developed world. Further, as competitive pressures increase, firms react by shifting burdens onto workers: replacing full-time workers with temporary, "contingent" workers who are not paid basic benefits; or shifting a larger share of the costs of benefits onto workers.

At the same time, government's ability to cushion market dislocation has been deteriorating. Government means-tested poverty programs lifted half the poor out of poverty in 1979, but only 42 percent today. The unemployment insurance system provided benefits to 48 percent of unemployed workers in the 1970s, but to only 37 percent of the unemployed in the 1980s.

Meanwhile, federal tax policy has increased inequality. The large income-tax cuts at the start of the 1980s benefitted most those in upper-income brackets, while rising regressive Social Security taxes have increased the tax burden on middle- and lower-income workers. Between 1980 and 1989, Social Security taxes rose from 30.5 percent of federal revenues to 36.3 percent while income taxes fell from 47.2 percent to 45.0 percent. Today 75 percent of families pay more Social Security taxes (including the employer's share) than income taxes.

FINANCIAL FRAGILITY

The growth of consumption in excess of production in the 1980s was fueled by a massive increase in debt. Corporations and households followed the lead of the federal government and ran debt obligations well above historic norms. This pattern has serious implications for the financial system. Financial institutions hold much of this debt, and the expansion of debt coincided with a failure of supervision over financial institutions. Regulators who believed that private markets always knew better than public authorities cut back on staff and turned a blind eye to destabilizing developments in the financial sector.

This phenomenon is seen most clearly in the savings and loan catastrophe. Changes in law gave these institutions much broader latitude in choosing investments, and many used this freedom to speculate on real estate, junk bonds and other exotic assets. Regulators had the power to halt such abuses, but they did not, at first because they were reluctant to second-guess the prudence of private investment decisions and later because they did not want to concede the extent of the problem. The true costs of this regulatory failure are only now coming to light. Because deposits were guaranteed by the federal government, these institutions were essentially permitted to gamble with public money. The Administration now estimates that the losses already exceed $100 billion. While this is the largest federal rescue program ever, there is reason to believe that even larger costs loom ahead.

Concern is also mounting about the commercial banking, pension and insurance sectors. Many institutions have large holdings of junk bonds and loans for questionable real estate and leveraged buyouts. This raises questions about the integrity of pensions for many workers and retirees, and the possible need for another bailout.

The risks posed by our increasing debt burden are difficult to assess with precision. Delinquencies on consumer installment debt are now at levels usually found only in recessions, raising questions about consumption should interest rates rise. The increase in corporate debt is levelling off, and the recent sharp declines in the junk bond market have slowed corporate takeovers. The ratio of debt to equity nonetheless remains unprecedentedly high. Rating agencies continue to downgrade corporate bonds.

If there is no recession from other sources, the economy may avoid a serious crisis from financial fragility. But computer simulations by two Princeton University economists indicate that a recession as severe as 1974-75 would push one in ten large corporations into bankruptcy; more heavily leveraged private firms presumably would fare even worse. A repeat of the 1981-82 recession, though less damaging, might still trigger a liquidity crisis.

Thus, recessions of a magnitude within our recent experience could trigger serious debt problems.

SLIPPING INTERNATIONAL LEADERSHIP

America's once-isolated industries now feel the full effects of global competition, and in such an interdependent world, our firms and workers will be increasingly influenced by the international economic system.

Economic conflicts among market economies have been growing in the 1980s. With the rapid decline of the preoccupying Soviet threat, tensions among western countries and within international economic institutions could well increase. There is an urgent need for American leaders to take the initiative, to improve the institutions and expand the stabilizers in the system. Instead of seizing this opportunity, American leaders seem content to let things drift, responding to crises rather than initiating the broad rethinking which the international economic system needs.

American leaders need to respond to six basic challenges:

Redefining National Security. During the Cold War, security was defined in military terms. The Soviet threat pulled public spending away from civilian priorities and toward a military establishment whose size had no precedent in earlier periods of peace. This shift of resources had costs for the civilian economy -- as our major allies relied on American strength rather than their own military spending. Whatever the rationale, American economic interests suffer when we devote 6 percent of our GNP to defense while the Japanese and Germans devote 1 percent and 3 percent respectively. The sharing of the cost of international security was on the agenda even before the dramatic events in Eastern Europe and the Soviet Union. This issue does not depend on the current reform process in the East.

It is now clear, as pointed out in recent Joint Economic Committee hearings, that security lies in the economic realm and not strictly the military. This has been recognized by the Department of Defense, which noted in its most recent study of *Soviet Military Power*:

> If the United States proves unable to compete effectively in areas of advanced technologies, it would incur the most severe economic and security consequences: markets would be lost, the US industrial base would erode, and the United States would become increasingly dependent upon offshore technologies for its defense at the same time as its economic health weakens.

Supporting Liberalization in the Centrally Planned Economies. The tide of reform now sweeping the planned economies is not only an important victory for our principles, it is also an important commercial opportunity. It is in our interest that reform continues, and that American-based investors and producers can participate in the growth of these regions. Today's euphoria about political liberalization should not blind us, however, to the difficulty of economic reform. The introduction of market prices and the ending of subsidies will increase unemployment and create hardship. Privatization will create speculators and manipulators whose obvious wealth may create social tensions in countries accustomed to enforced equality.

To maintain the will to reform, the developed market economies must find ways to smooth the process of liberalization and protect living standards. The external financing needs of economic reform will be large. Private investors will come forward over time as economic conditions improve; they cannot be expected to provide the resources needed by the public sector in these countries to finance the initial process of reform.

American responses to this financing challenge have been meager. This year, the Administration is requesting only $300 million for Eastern Europe, half of which is to fund legislation passed last year. Continued failure of leadership threatens three damaging outcomes. First, reform could collapse, restoring military rule and increasing the security threat. Second, if Germany and Japan take the lead in the financing process, their firms will reap the economic rewards of liberalization. Finally, if finance is inadequate, the reforming countries may be driven to emulate the export-driven growth strategies of Japan and the Asian NICs to earn foreign exchange.

Increasing the Pace of Adjustment in the Industrial World. There is a consensus among economists and financial leaders that large trade imbalances and the consequent flow of financial capital could destabilize the world economy. As the staff of the IMF noted in their recent *World Economic Outlook*:

> The prospect of large and persistent payments imbalances has raised a number of concerns. First, concern has been expressed about sustainability, in the sense that persistent surpluses and deficits might lead to an explosive spiral of rising interest payments and growing external asset and liability positions. Second, even if the stocks of external assets and liabilities tended to stabilize over time in relation to GNP, the continuation of large imbalances eventually might give rise to disruptive market reactions and exchange rate swings. Third, assuming that adjustment could take place without causing turbulence in financial markets, it could have certain undesirable consequences where the industrial countries are operating at high levels of resource utilization. Fourth, large trade imbalances -- no matter

how unjustified -- tend to generate pressures to restrict imports and limit foreign investment. These concerns support the view that large payments imbalances constitute an element of vulnerability for the world economy, and that external adjustment should be an important objective of macroeconomic policy.

These imbalances have two causes: the U.S. fiscal imbalance, and the import-restricting policies of such chronic surplus countries as Germany, Japan, Korea and Taiwan. The United States has done far too little about its domestic fiscal imbalance. There are no excuses for this behavior, and no progress is likely on the diplomatic front until we show the political courage to address our own economic problems.

Having said this, the behavior of the surplus countries remains unresolved. Japan's closed system still discourages imports, raises domestic prices and reduces consumption growth. Korea manipulates its currency for economic advantage. West Germany, Japan and most of the newly industrializing countries maintain relatively closed systems of equity ownership which discourage capital inflow and depress the values of their currencies. Addressing these problems should be a major goal of U.S. bilateral negotiations and U.S. multilateral diplomacy in the international financial institutions.

Maintaining Global Trade Growth. Although the General Agreement on Tariffs and Trade (GATT) has prevented a general rise in tariffs, it has not halted the increased use of non-tariff barriers such as quotas, "voluntary" restraint agreements, domestic content requirements, and subsidies -- the new tools used by many countries to distort trade.

Many trade disputes arise from differences in industry structure and government-industry relations. Our major competitor nations in East Asia and Western Europe, although they differ one to the other, tend to cooperate more among companies and with government. These differences make it more difficult to agree on broad international trade rules. In reaction to the growing trade distortions and declining effectiveness of GATT, many countries have sought bi-lateral or bloc solutions to their individual trade problems. New regional trading arrangements are springing up, most notably in Europe in anticipation of the 1992 market unification, and in the North America free trade agreement.

The important question for the international system is whether such arrangements will expand trade or merely divert it (shifting trade away from external partners and toward those within the bloc). History is not encouraging; some trading blocs have diverted rather than expanded trade. Improving on this history is particularly important to the United States, which needs access to export markets to correct our enormous trade deficit. It is discouraging that U.S. negotiating objectives appear focused on specific sectors or issues (services, intellectual property) rather than on the broader questions of a trading system that expands world trade.

Restoring Growth to the Developing World. In Latin America, the 1980s is known as the "lost decade" -- a protracted period when output stagnated, inflation soared, incomes fell and countries lost their places in the world economy. Conditions in Africa were even worse, and only slightly better in the Middle East and Asia outside the four "newly industrializing countries" of Taiwan, South Korea, Singapore and Hong Kong.

The causes of economic stagnation in the developing world are many -- irresponsible government policies, unmanageable population growth, droughts, wars, famines, ethnic conflict -- and often beyond the reach of international economic policy. But policy has contributed in at least three ways.

First, the developed nations have allowed the international debt problem to fester for a decade, rather than acting to permit responsible growth. The Brady Plan was a step in the right direction, but progress has been glacial. The failure of commercial banks to embrace the "new money" option in the package for Mexico will hinder access to capital to sustain development. Second, the international development institutions have uncoordinated missions and resources. Until recently, the World Bank has been shifting away from its traditional infrastructure projects toward "policy-based lending" to support changes in policy in developing countries. The International Monetary Fund is hampered by arrears as its short-term lending perspective conflicts with many developing countries' need for long-term capital. Third, the thrust of the international development effort has missed the issue of environmental sustainability. Natural resource depletion -- particularly deforestation and topsoil erosion -- is a major cause of poverty in much of the developing world, and too many "development" policies actually encourage these destructive trends.

Given these problems, international leadership should re-focus on creating rapid, environmentally sustainable growth in the third world. We should pursue this international development agenda and simultaneously reexamine our foreign aid policy -- which is, unfortunately, largely irrelevant to the major issues in this field.

Reversing Environmental Deterioration. "Sustainable development" is not a problem only for the developing world. Ozone depletion, atmospheric warming and acid rain have brought home the World Commission on Environment and Development's warning:

> Many forms of development erode the natural resources upon which they must be based, and environmental degradation can undermine economic development.

A new international framework for environmental policy and regulation is required. The recent treaty limiting the production of chlorofluorocarbons (CFCs) is but the first step; Administration resistance forced European nations to take the lead. The current Administration continues to resist calls for a summit meeting on atmospheric warming.

Our lack of an energy policy further weakens our leadership on environmental matters. Our allies will not follow our environmental initiatives when we consume twice the energy per unit of production as other developed countries, and our domestic environmental regulation has been ineffective. The recent decisions merely to "study" global warming, and to veto legislation which encouraged recycling (because fees on solid waste producers might violate the Administration's "no new tax" pledge) raise serious questions about this Administration's commitment to environmental quality.

We could benefit by the world-wide search for environmental quality. Environmentally safe technologies will provide a major marketing advantage, and a tough, market-based approach to environmental regulation could pay big commercial dividends. The United States should also ensure that international environmental policy leans toward markets rather than regulation.

Environmental quality is a national asset which is degraded by pollution. At present, there is no market price for this degradation, and firms find that it pays to pollute. The federal government must shift this calculus by setting reasonable "user fees" which reflect the true cost of environmental deterioration. The United States should adopt the practice of every other industrialized country and levy increased fees on energy consumption. Such fees would shift production toward more efficient and less polluting products and services and reduce the risk of climate change through carbon dioxide emissions, while also easing the budget deficit and interest rates.

POLICIES TO MEET THE CHALLENGES OF THE 1990s

The 1980s have demonstrated the flexibility and vitality of the American economy. With better policy in the 1990s, we can once again set the world standard for economic performance. The need for a change of course is now acknowledged on both sides of the political aisle. The Administration's new budget parts with the past by acknowledging economic problems and abandoning the rhetoric of complacency, but does not follow the analysis with policy changes. New rhetoric is not enough. Actions, not words, will build an economy on solid foundations of investment, productivity and fairness. The alternative is continued drifting, pushing the growing costs of eventual adjustment off onto future generations.

Unfortunately, behind new talk of fiscal responsibility, investing in the future, protecting the environment and rebuilding infrastructure, the proposed budget tells an old story. Deficit projections are based on fanciful economic and technical assumptions and a shift of public responsibilities from the federal to the state and local level. Investments are increased very little in most areas, and there is no redress for the distributional inequities that have built up over the 1980s.

Three critical policy areas highlight the problem. First, proposed defense spending does not reflect reduced Cold War tensions, and there is no sign of a systematic reassessment of U.S. security needs. Second, the Administration provides no credible remedy for the implicit funding of general outlays through Social Security. Social Security is running large annual surpluses to build a reserve against the retirement of our "baby boom" generation. While the trust fund itself cannot fulfill that obligation, the increased national savings in the trust fund could be invested to build an economy stronger and more capable of funding future benefits. Instead, the rest of the federal government has run even larger deficits, negating and absorbing the savings in the trust funds. The United States became a net debtor in the 1980s, incurring obligations to foreigners that will detract from our ability to meet our Social Security commitments. The proposed budget continues this practice, while promising to end it at some later date. Third, the Administration proposes an inadequate response to our widely recognized needs in education. It would expand some important programs, but these initiatives do not go far enough. The President wants full funding for Head Start -- and then defines "full funding" as serving 70 percent of all eligible four year olds, rather than the entire eligible population of three-, four-, and five-year olds. This initiative is paid for essentially by reducing other worthy education and training programs; total spending for education would not increase by enough to maintain current programs after inflation.

On these and other issues, the budget ducks the tough problems. We believe that we must put more than rhetoric to work in five critical areas:

Raising the Investment Rate. In today's competitive economy, we can no longer be content with a lower investment level than our major competitors, a school system far less effective than theirs, and a rapidly deteriorating public infrastructure. We need to increase both private and public investment, and to shift priorities toward the greatest long-run payoffs in productivity.

Our low private-sector investment is largely a result of high real interest rates, which in turn reflect the pressure put on capital markets by large federal deficits. The Administration has proposed a cut in capital gains taxation to encourage investment, but this is mere tinkering. As was pointed out in a recent Committee hearing, the capital gains tax cut would encourage investment by no more than would a 5-basis-point reduction in corporate borrowing costs (for example, from 8.00 percent to 7.95 percent). Serious deficit reduction, discussed in the next section, is the best way to lower business capital costs and revive investment.

Public investment is also critical to our economic performance. This means shifting resources from current consumption -- both public (including defense) and private -- toward investments in education, infrastructure, and technological innovation. In education, our poor performance in basic literacy and numeracy demands improved primary and secondary education.

Educators agree that early intervention -- through such programs as Head Start -- has the greatest long-term payoff in educational performance. Yet Head Start covers only 18 percent of eligible children in the three-to-five year old age group, and the additional $500 million requested by the Administration will increase coverage only to 24 percent. Full funding for Head Start and Chapter I compensatory education programs would require $5 billion to $10 billion in new federal spending. All children -- not just the disadvantaged -- benefit from education earlier than the start of kindergarten. A case can be made for starting free public education at age three or four, which would also provide quality child care for working parents.

Finally, it is clear that American secondary schools cannot attract enough qualified teachers, particularly in math and science education, at the rates of pay and benefits now prevailing throughout most of the country. The greatest educational deficiencies occur in the states and localities least able to increase spending on teacher salaries. The federal government could make teaching more attractive by providing support for graduate education for teachers and by funding mid-career training grants and sabbaticals. The Senate Labor and House Education and Labor Committees are presently developing incentives to attract teachers.

This basic program for investment in human capital -- full funding for Head Start and Chapter I, adequate child care, science and math education excellence, and a national system to increase the attractiveness of teaching -- would cost about $10 billion per year in increased federal funding.

Infrastructure needs are well defined, but just returning public infrastructure investment to the GNP share of the 1960s would require $80 billion in new spending each year, and even that would not reverse the past decade of deterioration. While 75 percent of this increase would be a state and local responsibility by historical patterns, the federal government is responsible for an overhaul of the air-traffic control network, additional airports, a more energy-efficient system of surface transportation, new water and sewer systems in older areas, and the creation of a network of fiber-optic communications for the information economy. Instead of facing up to the infrastructure problem, the

Administration refuses to spend monies already in the airport trust fund -- while requesting additional taxes for this fund -- and cuts sewage treatment grants.

Our leadership in basic science has come in large measure from public support; we should accept a similar public responsibility for supporting non-proprietary research in engineering -- particularly critical generic technologies, from optical imaging to metal shaping. The Administration has resisted public support for generic technologies, on the ground that it would amount to an "industrial policy." Despite this rhetoric, the Administration consistently funds "industrial policy" programs in the Defense Department and NASA. Because the threat to our future security comes as much from commercial competition as military aggression, it is time to abandon this inconsistent position on federal support for technology. Congress has already initiated a process to identify critical technologies; we must devote resources to this effort. Given our Nation's resources, the sums involved are not large: while the technology arm of the Defense Department, the Defense Advanced Research Projects Agency (DARPA), spends roughly $1 billion per year, similar funding for civilian technologies would have an enormous impact on our competitiveness in commercial technologies.

Federal policy should promote the diffusion and adoption of existing scientific and technological knowledge, not just the creation of new knowledge. Total state and federal spending on "manufacturing extension services" is well under $100 million a year. That is less than one-third of the budget of the Agricultural Extension Service, even though agriculture contributes only two percent to GNP while manufacturing contributes 19 percent. Our efforts also compare poorly to Japan's, where a massive network of public testing and research centers provides technology extension to smaller manufacturing firms. In 1985, Japan, with an economy roughly half the size of ours, had 185 of these centers, with 7,000 employees and annual funding of $500 million -- ten times the U.S. effort. Despite this disparity, the President's FY91 budget would cut spending for the technology extension provisions of the Omnibus Trade Act.

Raising the Savings Rate. American firms and households save less than a third as much of their income as those in other industrial countries; this keeps interest rates higher here, and adds to our dependence on foreign savings. It also makes the federal deficit more important. High savings countries can finance a government deficit painlessly; low savings countries cannot. Although the federal deficit is declining as a share of GNP, it continues to absorb implicitly roughly 60 percent of our paltry net domestic private savings.

The United States is a wealthy country, but it has low savings. We tinker too much with the tax code. Tax breaks which reward past or already planned savings make the problem worse, because they reduce government savings (by cutting revenue) by an amount greater than the increased private savings. "Back-loaded" savings proposals have a lower initial revenue loss, but their long-term cost would be enormous, and there is no reason to expect that they will produce more private savings than public dissavings.

These problems mean that cutting the deficit is the surest way to increase national savings; it would also end the example of profligacy that the federal government has set for private savers. The current budget process is more hindrance than help. Despite broad support for planned deficit reduction, the FY90 budget will likely miss the Gramm-Rudman target by at least $38 billion, while the CBO baseline for FY91 is more than $74 billion above the target. Even more discouraging, the gap between general revenues and expenditures is far higher than the measured deficit because it is masked by mounting surpluses in the trust funds (including Social Security).

The Gramm-Rudman deficit reduction process has failed. While it may have helped control spending at first, it now encourages accounting games rather than true deficit reduction. First, the legislation requires that we meet targets only for projected deficits, not actual deficits. This encourages the President to minimize the projected deficit with overly optimistic economic forecasts, and the Congress to adopt budget gimmicks, so that they can meet the target without facing up to the real problem. Second, meeting the current budget target could damage the economy. The target for FY90 was $100 billion, but even the Administration expects a $124 billion deficit, driven up in part by false savings undertaken to satisfy Gramm-Rudman in the past. Weakness in the economy, particularly in corporate profits, is likely to put the deficit significantly above that. Meeting the FY91 target of $64 billion therefore could involve a cut of as much as $80 billion, nearly 1.5 percent of GNP – enough to disrupt the economy. Third, reduced world tensions following events in Eastern Europe have transformed the Gramm-Rudman sequester. In the past, the threat of sequester forced compromise; now it is nothing more than a thoughtless and mechanical way of achieving defense cutbacks of the right size but the wrong kind.

We need substantive policies, instead of promises, to produce a rapid and credible move toward unified budget balance within a few years. Genuine deficit reduction requires change in both revenues and spending. At the same time, the country must address its substantial unmet needs in critical areas. We would like to believe that the federal government can balance its books and meet pressing needs by some combination of more rapid economic growth, the presumed "peace dividend," and cuts in domestic programs. Unfortunately, the facts do not support this rosy scenario. Excessive reliance on overly optimistic assumptions has been a major cause of deficit disappointment in past years. The peace dividend will be substantially smaller than funding required for domestic priorities, and discretionary spending outside the military sector has been deeply cut already during the 1980s – witness our weakness in education, environmental protection, infrastructure, and law enforcement.

This leaves us with two painful alternatives: Either neglect important national needs -- as the Administration has done in its budget -- or exercise the political will to meet public obligations in a fiscally responsible manner. We believe the latter course is better, and call on the Administration to support a package of spending and revenue measures sufficient to balance the budget and rebuild the foundations of a competitive economy.

Reducing Financial Instability. The legacy of the 1980s experiment with wholesale financial deregulation -- over-leveraged corporations sliding into bankruptcy, and financial institutions gambling with taxpayer-insured deposits -- shows the need for new toughness in safety and soundness regulation. Because financial innovation has created a unified capital market, we need a unified structure of financial regulation. Different markets should not operate with different margin requirements, different disclosure rules, and different capital standards; and we must prevent financial institutions from speculating with funds backed by public deposit insurance. Finally, supervisory institutions must have the financial and human resources to do their job of limiting destabilizing risks to the financial system, including pension funds and the insurance sector. It is discouraging that the President's FY91 budget contains personnel increases only for the Securities and Exchange Commission and not for either the Comptroller of the Currency or the Office of Thrift Supervision.

Increasing Economic Fairness. Stagnating incomes and growing inequality came from past policies which favored current consumption over investment. High interest rates and an overvalued dollar hit particularly hard at the incomes of factory workers; some reduction in these pressures should come from increased savings and investment. But unfairness also flows directly from government policies. Unfortunately, testimony to the Committee by Administration spokesmen shows no concern about the serious and growing tax and income inequality.

First and foremost, policy must address the shifting of the tax burden from rich to poor. Supply-side tax cuts did not deliver the promised economic growth, but they did sharply reduce the progressivity of the tax code; and cuts in income taxes have been offset by increases in payroll taxes, which fall more heavily on middle- and lower-income families. According to CBO estimates, the lowest 20 percent of all families ranked by income will pay 9.7 percent of their income in federal taxes in 1990, compared to 8.4 percent in 1980; for the highest 5 percent of families, the tax burden will fall from 29.5 percent to 26.7 percent over the same period. Some current proposals continue this trend of cutting taxes for the best-off. Both the economic merits and the distributional implications of tax proposals should be examined carefully. When alternative policies to accomplish the same goal are evaluated (for example, a cut in capital gains taxes or the expansion of Individual Retirement Accounts to increase private savings), the choice should give the bulk of any tax relief to those middle- and lower-income families whose taxes rose most sharply in the 1980s.

Second, we must give people the skills to compete in today's economy, through investments in primary and secondary schooling, and also expanded vocational education and adult training. Third, it is time to re-examine unemployment compensation. We designed this system years ago to deal with cyclical swings and slow structural and technological change. Now we need more emphasis on education and training rather than merely a cushion for job search. Fourth, as firms come under increasing competitive pressure, we need to recognize that basic benefits are a responsibility of society as well as the employer. We need to create affordable housing to deal with homelessness, insure access to health care for those without high-paying jobs, and remove inadequate family income as a barrier to a child's college education.

Improving the International Framework for Growth. U.S. leadership is needed in today's world economy. Working with other industrial nations, the United States can promote growth and democracy abroad which would, in turn, increase U.S. exports and jobs and decrease our dependence on foreign capital. We have failed to lead an international response to the opening of Eastern Europe, the export drive of East Asia, the debt burden of the developing world, and the trade imbalances among the industrial countries.

These developments create uncertainty in the financial markets and deter investors. Unfortunately, three pillars of the post-World War II economy, the World Bank, the International Monetary Fund (IMF), and General Agreement on Tariffs and Trade (GATT), are structured more for the issues of a generation ago than for those of today. As international flows of private capital have soared, the need for international policy coordination has increased, but the role of the IMF has narrowed; floating exchange rates have displaced the pegged rates the IMF enforced, and many developing nations have credit needs that cannot be resolved within the IMF's five-year repayment period. The World Bank was created to provide long-term credit in developing countries with limited access to international capital markets. In recent years, however, the World Bank has shifted from infrastructure finance to "policy-based lending," making the distinction between Bank and IMF loans a matter of their time for repayment rather than their conditions and purpose. The GATT was devised primarily to prevent an escalation of tariffs such as occurred in the "trade wars" of the 1930s. It has been far more successful in reducing tariffs than in reducing other trade distorting measures. Non-tariff barriers such as quotas, "voluntary" restraint agreements, investment requirements, domestic content requirements, and official subsidies of many countries -- including the United States -- appear to have grown more common. We must reshape those institutions or create new ones to resolve the new international economic problems.

Our Nation's relative economic strength has slipped dramatically during the 1980s, paralleling our descent from net creditor to net debtor status. We cannot lead those from whom we must borrow money. And with national living standards determined by international competition, we cannot accept this decline with equanimity. We must get our domestic economy in order. Federal deficit reduction, increased national savings and a shift of resources toward investment are all essential for international leadership. Both at home and in the international arena, we need bold initiatives, not more tinkering.

In the GATT, the IMF, or the G-7, the United States needs a broader and more fundamental negotiating agenda. We should seek action against countries running chronic and excessive surpluses as well as deficits. We cannot expect others to abandon all support for their high technology/growth industries, but we can seek limits on financial support and trade barriers. Finally, the rapid emergence of East Asian and possibly Eastern European trading nations calls for a reappraisal of the rules for trade conflicts between nations with different economic structures.

The United States has an unparalleled opportunity to create and refashion institutions to address our international economic problems. This July, the United States will host and set the agenda for the annual economic summit of the G-7 nations. Also this year, we negotiate a major quota increase for the IMF, a new round of trade agreements under the GATT, and the conditions for entry of Eastern Europe into the world market economy. In negotiating an IMF quota increase, the United States has an opening to negotiate a clear and constructive IMF mandate. In all of these discussions, the institutions can be restructured to resolve trade conflicts between nations with fundamentally different economic systems -- including the Eastern European economies (including the Soviet), and the newly industrialized Nations of East Asia. Unfortunately, in all of these cases, the United States appears to be skirting the fundamental issues rather than pursuing basic reform of the institutions.

CONCLUSION

This year's budget submission is heavy on rhetoric and light on policy. The mix should be the reverse. Unfortunately, addressing our major economic problems -- a buildup of debt and an emphasis on consumption, rather than investment -- requires discipline rather than immediate gratification; but the longer the discipline is postponed, the more painful it will have to be.

ADDITIONAL VIEWS

SENATOR LLOYD BENTSEN

I congratulate Chairman Lee H. Hamilton and the majority staff of the Joint Economic Committee for producing the comprehensive *Majority Views*. While I do not support all its recommendations, the *Views* is a bold and detailed statement of America's economic prospects and challenges as we enter the last decade of the twentieth century. These additional views are appended to clarify my own position on issues discussed in the *Views*.

America's preeminent economic position in the world was dramatically eroded by economic policies during the eighties. Those policies encouraged consumption at the expense of savings and investment, shrank America's industrial base, produced sluggish productivity, neglected national priorities such as education, drug prevention and the environment, and hobbled the critical high technology and traded goods sectors. One result is that America has become the world's heaviest debtor, owing $ 630 billion abroad -- a nation excessively reliant on foreign technology, capital and the largess of strangers. This loss of economic independence means domestic interest rates are determined more by events abroad than at home. Forced to pay record real interest rates to borrow abroad, American GNP and investment slowed in the eighties -- in sharp contrast to our major economic challengers. Between 1979 and 1988, for example, real average family income here rose less than one percent annually -- nine percent overall -- to $ 38,608, while real family income in Japan soared a solid 25 percent to top the U.S. at $ 39,828.

The Budget Deficit: Policies to rebuild America begin with eliminating the budget deficit. There are many partisan deficit reduction proposals, some focusing on spending cuts and others involving taxes as well. But the only effective proposal must be bipartisan because history shows that real budget progress hinges on strong, bipartisan cooperation.

The creaky Gramm-Rudman-Hollings budget process has enjoyed only limited success because process in a poor substitute for cooperation. The possibility of recession highlights the dangers of continued budget conflict rather than cooperation.

Cooperation is necessary to tackle other questions posed in the *Views* as well, including tax fairness, the adequacy of our safety net, financial regulation reforms such as margin requirements and especially, rebuilding national savings. Regarding savings, deficit reduction is the key to improved national savings, but evidence shows that well-crafted Individual Retirement Accounts boost national savings as well. At the same time, in light of questions concerning shifting tax burdens during the eighties, the impact of any proposed tax change should be carefully examined.

Trade: In dramatic contrast to foreign government assistance to firms, American trade policy has generally proven inadequately supportive of the traded goods and high technology sectors. Tattered income growth and record trade deficits are the result. It is time that Washington exercised a firm hand in both reducing specific trade barriers, and in crafting a freer international trading regime to permit the U.S. to grow out of the trade deficit.

Defense: The economic component of American national security was weakened by the excess defense build-up, weak investment and deficits of the eighties. And I agree with the *Views* that proposed defense spending does not reflect reduced cold war tensions.

Environment and Energy: The *Views* recommends user fees to discourage environmental pollution and promote energy efficiency. I supported fees on CFC's to stem ozone depletion and to establish superfund as well. But I am not convinced that broadly applied user fees are preferable to targeted fees, or to regulatory steps such as vehicle fuel efficiency standards with proven track records. At the same time, I am convinced that Washington must move to stem the startling jump in oil imports. Rising import dependence threatens to reverse progress on trade and has set the stage for another oil embargo. Annual oil imports will exceed one-half of domestic consumption in 1991 or 1992, and the administration should cooperate with Congress on policies to cap imports at that level.

Lloyd Bentsen

Lloyd Bentsen

CONGRESSMAN AUGUSTUS F. HAWKINS

I commend Chairman Hamilton, the JEC staff, and the other Members of the Committee for their dedication to producing a clear, concise analysis of the American economy. Both the *Report* and the *Majority Views* present the strengths and weaknesses our Nation faces as we enter the last decade of this century, with the *Majority Views* being right on target in calling for specific investments in education, training, and other programs that address our human deficits, so that we might strengthen our international competitive position and our standard of living at home.

While I am pleased to see the Chapter on "To Maximum Employment" in the joint *Report*, and the analysis of structural employment weaknesses, I must take exception at the impression that we have reached a so-called full employment level. As this Report goes to print, national unemployment rates continue to hover at around 5.3 percent. However, when those working part-time for economic reasons, and discouraged workers, who are not now currently counted as officially unemployed, are added to the official unemployment rate, we find that well over 7 percent of the labor force is involuntarily idle.

The Employment Act of 1946, as amended by the Full Employment and Balanced Growth Act of 1978, clearly mandated economic policies that would reach 4 percent unemployment, and lower levels of joblessness thereafter. In 1990, we have yet to achieve that objective. The thrust of the Full Employment Act was to reorder economic and budget priorities, to place reduction of unemployment and inflation at the center of the policy decision making process. In 1990, we have yet to achieve that objective, as well.

The Joint Economic Committee should identify how specific policy and programmatic recommendations will result in the established goals of full employment and price stability. The goal-setting procedure mandated in the Full Employment and Balanced Growth Act should be the vehicle for recommending policy priorities, and setting timetables for achievement of the goals in order to hold policymakers accountable for their decisions.

The economic policies of the last decade have left the United States in a weakened position as we struggle to prepare for the challenges and complexities of the next century. We should use all tools at our disposal to achieve full employment and balanced economic growth.

Augustus F. Hawkins

Augustus F. Hawkins

Figure 1.4 -- Inflation, as measured by the Consumer Price Index

Year	Annual Percent Change in the CPI-U
1980	12.5%
1981	8.9
1982	3.8
1983	3.8
1984	3.9
1985	3.8
1986	1.1
1987	4.4
1988	4.4
1989	4.6

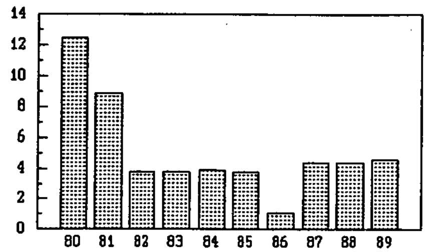
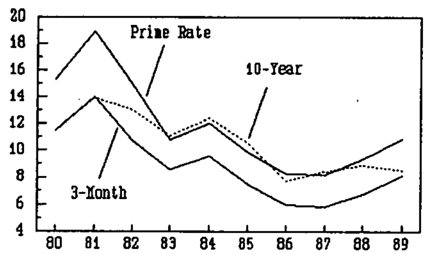


Figure 1.5 -- Interest Rates

Year	3-Month T-Bills	10-Year Constant Maturity	Prime Rate
1980	11.5%	11.5%	11.5%
1981	14.0	13.9	18.9
1982	10.7	13.0	14.9
1983	8.6	11.1	10.8
1984	9.6	12.4	12.0
1985	7.5	10.6	9.9
1986	6.0	7.7	8.3
1987	5.8	8.4	8.2
1988	6.7	8.9	9.3
1989	8.1	8.5	10.9



We are confident that economic policy is now basically sound. However, some concerns remain. Certain regions and sectors of the economy are growing very slowly, or are even declining, with unpredictable effects on consumer confidence and purchasing decisions. The Fed occasionally reverts to a demand-management approach to monetary policy, raising the risk of stagflation. Recent weakness in foreign financial markets could have repercussions on our own.

Nevertheless, we open the 1990s with exports rising rapidly, the dollar strengthening, the deficit declining as a percent of GNP, good prospects for those seeking jobs, and a continuing movement toward the goal of long-term price stability.

Section 2

MONETARY POLICY

The experience of the 1980s has challenged macroeconomic theory, frequently revealing how modest is our understanding of complex economic relationships. We are more persuaded today than a decade ago that monetary policy is the primary determinant of inflation and the short-term stability of the economy. The clearest lesson of the 1970s is that micromanagement of the economy is not possible by use of macroeconomic tools. The 1980s have taught us that a consistency of monetary policy is essential for stable growth.

The prevailing demand-management thinking of the 1970s supported tax increases as a way to reduce inflation and interest rates. According to this view, higher taxes could accomplish this by reducing aggregate demand and the budget deficit, thereby lowering both inflationary pressures and credit demand. This ignores the negative economic impact of higher taxes, and the stimulation of federal spending that usually follows tax increases. Furthermore, and most importantly, this perspective failed to recognize that inflation is a monetary phenomenon. Rapid money growth will lead to inflation regardless of whatever fine tuning is attempted in fiscal policy.

The experience of the 1980s showed that interest rates and inflation depend much more on monetary policy than on deficits. As long as monetary policy is directed at long-term stability, interest rates and inflation can be reduced rapidly. Such a policy, and its constructive result, were the norm for the U.S. experience prior to the 1960s. The hands-on concept of balancing fiscal policies with monetary policies precipitated the painful lesson of the 1970s, that fiscal policy plays little or no role in creating or combating inflation, while a monetary policy aimed at controlling short-run interest rates is likely to lead to instability in the long run.

On balance, we are pleased with the results of the Federal Reserve's conduct of monetary policy during 1989, and so far in 1990. However, we have several concerns that relate to meeting the challenge of achieving long-run price stability without producing short-run volatility. As recent Fed testimony indicates, the Federal Reserve places substantial emphasis in the conduct of monetary policy on the restraint of GNP growth to promote price stability. This raises the prospect of stagflation where monetary policy slows the economy yet leaves inflation too high. Further, if demand is managed through an interest rate targeting policy, this can become procyclical, distorting the market allocation function of interest rates and tending to increase the amplitude of business cycles rather than smoothing

DISSENTING VIEWS

SENATOR JEFF BINGAMAN

While I appreciate the efforts of Chairman Hamilton and the staff of the Joint Economic Committee to craft an annual report acceptable to all members of the Committee, I regret that I am unable to endorse the *1990 Report*. I believe that the *Report* does not adequately capture the economic difficulties facing America and leaves the impression that all is well with the U.S. economy. I strongly believe that this is not the case and must therefore decline to sign the *Report*.

One challenge that the *Report* seriously understates is the decline of our international competitiveness. This is, I believe, one of the central problems we face today, not a distant issue to be faced sometime in the future or an issue that we can simply ignore and hope it goes away. We must act now and not let ourselves be lulled into a false sense of security. In many respects, complacency is our worst enemy.

America still possesses enormous economic strength, as the *Report* points out. However, the trends are against us. We continue to run large Federal budget deficits, large trade deficits and have seen the slippage of the United States from a creditor Nation to the world's largest debtor Nation.

Workers' real wages continue to grow slowly after stagnating for most of the decade to the point where it takes two-wage earners in many families simply to maintain their standard of living; inequalities in income and wealth are growing; the rate of homeownership has declined; and the personal savings rate has plummeted.

We continue to see evidence of our loss of technological superiority. Recently, the Department of Defense released its *Critical Technology Plan for 1990*. In this report, DoD states that Japan is significantly ahead of the United States in five of the 20 technologies listed and is essentially on par with us in three others. The technologies in which Japan exceeds us are all technologies with wide civilian and military applications -- semiconductors, photonics, composite materials, superconducitivty, and biotechnology.

U.S. productivity growth continues to lag behind that of other major industrialized nations, as does per capita spending on civilian research and development. As the *Majority Views* point out, some 20 percent of the U.S. adults are functionally illiterate compared to a minimal percent in Germany and Japan, and U.S. students continue to routinely score at or near the bottom in international tests in math and science.

As I stated in last year's *Report*, this is not a picture of a healthy and successful economy, but of a very vulnerable one.

The *Report*, unfortunately, does not adequately cover these concerns. It says little about the budget deficit and the fact that what modest growth we have had during the 1980s has been built on the massive Keynesian stimulus of record government borrowing. It explains away the trade deficit as solely a macroeconomic problem, ignoring the very real structural problems. It ignores the past decade of neglect by the Federal government in education and downplays those areas where experts agree that the Federal government could do more. It does not speak about the erosion of our manufacturing base including the serious dependence of our defense industrial base on foreign sources of technology. It evades a discussion of the regressive tax system imposed during the past decade under the guise of tax cuts. Finally, it completely misses our growing energy problems.

As the *Majority Views*, which accompany the *Report*, point out, these are problems that we must solve today. The "Don't Worry -- Be Happy" school of economics that has prevailed for the past decade is only postponing the problems. Unless we face our problems and can turn the negative trends around, our children, and our children's children will not have the same economic opportunities that we have enjoyed in the past.

Jeff Bingaman

PREFACE

Last year's *Minority Views*, and many previous ones, have presented and defended an optimistic economic outlook. The optimistic views taken by the Republicans have proven realistic -- the economy has done remarkably well.

The success of the economy has not been random luck. U.S. economic policy is now built on generally sound principles -- lower taxes on a broad base, a monetary policy whose objective is price stability rather than GNP growth management or interest rate management, and a commitment to market rather than government solutions.

While these economic policies do not guarantee recession-free growth, they are necessary conditions for that growth. When any of these conditions is absent, all attention is turned to reestablishing them, as was the situation in the early 1980s. While sound conditions are present, attention can be turned to our Nation's many challenges, opportunities, and problems.

The 1990s promise to be a remarkable decade. In Eastern Europe we are seeing an entire concept of government and economic management crumble, and we look forward to seeing nations reborn. All but a few recognize that economic theories of socialism and central government control were themselves the failure that led to decades of humiliation for humanity. It is instructive to realize that such an inhumane economic theory could stand for more than a 100 years and have advocates through 70 years of disastrous experimental results. We wonder whether the welfare state and demand-management policies, both based on flawed models and on the contention that government spending can be used to enhance economic growth and regulate inflation, must survive as long.

The first section of this year's *Minority Views* gives an update on the state of the economy. Growth in GNP, investment, and employment have continued throughout the 1980s' expansion, but improvement in inflation and interest rates has stalled. The section recognizes that risks exist in the economic outlook, and that some areas of the country are doing less well than others, presenting economic challenges.

Sound monetary policy is crucial to sound economic policy and a sound financial system. Section 2 reemphasizes this, and calls for a redoubling of our efforts to avoid the monetary policy mistakes of the past. It urges avoidance of exchange rate intervention and efforts to weaken the value of the dollar.

Budget policy has for too long been dominated by an analysis of aggregates and of ways to "manage" the economy. For seven years and more, such macroeconomic notions of how the economy operates have made news headlines. The "twin deficits" became the conventional framework for predicting serious problems for our economic system. Section 3 presents the hopeful view that the conventional wisdom may now be moving toward an improved understanding of the economy, in which the role of government can be discussed in terms of its direct impact on the behavior of consumers and businesses, and on taxpayers and beneficiaries of government spending.

Selective use of data and shifting interpretations of that data are sometimes used to build the case that a problem exists where one does not. Section 4 explains why this occurs and rebuts the latest "data attack" with regard to income distributions. Another one of the off-the-mark notions has been the view that America is a nation in decline. Section 5 calls for an end to the defensiveness that has become dangerously characteristic of our view of our Nation in its relationships with other countries. The world's economic opportunities are expanding in direct proportion to its embrace of freedom and market economics, concepts integral to our society for 200 years. We should approach these opportunities with more confidence in our convictions.

The final section, Section 6, discusses the growing influence of pension funds in the context of microeconomic challenges. With sound economic fundamentals now in place, the potential of a free and dynamic economy to address successfully such challenges is clear.

Section 1

STATE OF THE ECONOMY

The following is a brief statistical review of the performance of five key economic indicators: growth in gross national product (GNP), unemployment, inflation, interest rates, and investment.

Each shows the positive trend established in this decade. With the economic expansion in its eighth year, unemployment falling for seven years in a row, and investment and exports growing rapidly, the economic expansion set new records for economic health. The level of real investment has grown 61 percent over the last seven years. Only one other postwar period matches this investment growth -- the early 1960s, when the Kennedy tax cut sparked a supply-side expansion.

The graphs disclose one of the real challenges for the 1990s, achieving more stable prices and the resulting reduction in interest rates that would go with it.

Figure 1.1 -- Real GNP Growth

Year	Percent Change from Previous Year
1980	-0.2%
1981	1.9
1982	-2.5
1983	3.6
1984	6.8
1985	3.4
1986	2.7
1987	3.7
1988	4.4
1989	3.0*

*Revised

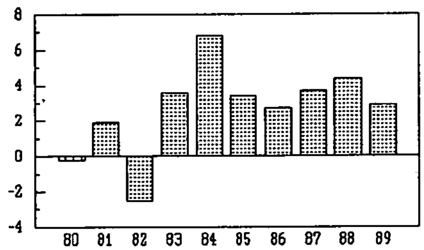


Figure 1.2 -- Unemployment

Year	Unemployment Rate (Civilian Workers)
1980	7.1%
1981	7.6
1982	9.7
1983	9.6
1984	7.5
1985	7.2
1986	7.0
1987	6.2
1988	5.5
1989	5.3

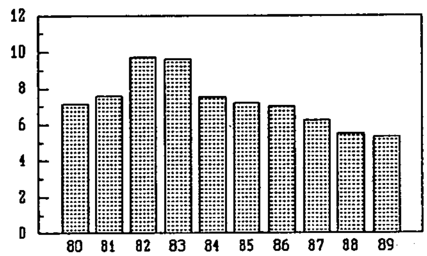
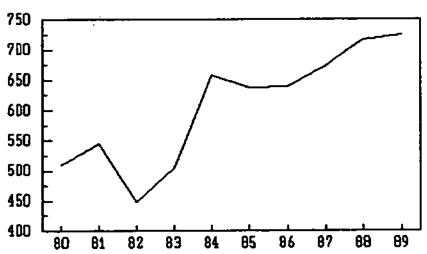


Figure 1.3 -- Gross Private Domestic Investment, in 1982 dollars

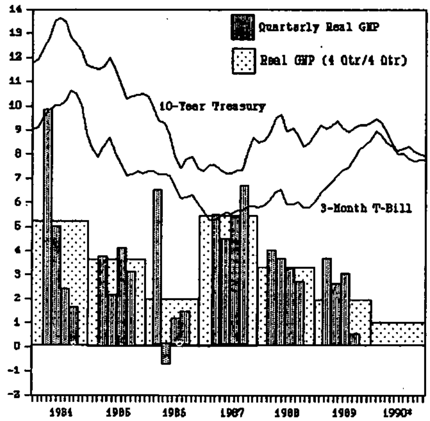
Year	$Billions
1980	$509.3
1981	545.5
1982	447.3
1983	504.0
1984	658.4
1985	637.0
1986	639.6
1987	674.0
1988	715.8
1989	720.7*

*Revised



them. This was the lesson of the 1950s. An equally dangerous mistake would be the placement of undue emphasis on the dollar's foreign exchange rate with the currencies of our major trading partners. As the Council of Economic Advisers (CEA) observed in its 1990 report, "...the problems associated with short-term [exchange rate] volatility may be over stated." Moreover, "Most studies have concluded that sterilized intervention is unlikely to be an effective tool for moving exchange rates...." In addition, a short-run concern with trade balances would run the risk of upsetting a painfully gained success in domestic price level stability.

Figure 2.1 -- Interest Rates and Real Economic Growth



Source: CEA
*Projected

Federal Reserve policies to raise or lower interest rates are often discussed in terms of the effect on markets in the next one or two quarters. Legislative and Executive Branch officials call on the Fed to tighten against inflationary pressures or ease before contractionary forces can gain momentum. An economic model developed by David Ranson suggests that changes in interest rate policy will have their most powerful consequences far beyond the immediate economic horizon, and therefore an attempt to conduct macroeconomic policy at the periodic meetings of the Federal Open Market Committee may be among the more destabilizing types of micromanagement.

Section 3

FISCAL POLICY, TAXES, AND THE BUDGET

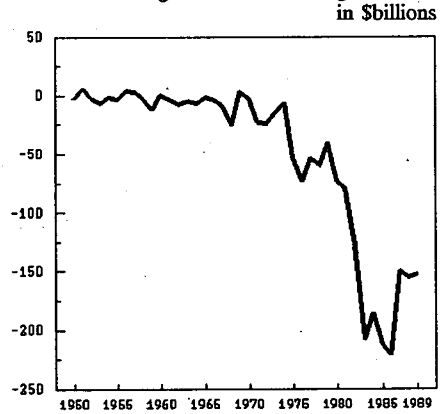
Since World War II the theory of fiscal policy has been dominated by the view that government could fine-tune the economy by manipulation of federal outlays, revenues, and deficits. Discretionary fiscal and monetary policy were viewed as tools of macroeconomic policy through which government officials could guide the economy to desired levels of income, output, employment, unemployment, and inflation. This perspective rested on the notion that government policymakers had the necessary information and understanding to determine or calibrate economic conditions through positive action.

Over the last two decades, this assumption has become untenable with new recognition of the limitations of government action. In his 1974 lecture in acceptance of the Nobel Prize in economics, entitled, "The Pretense of Knowledge," F.A. Hayek explained that government simply cannot assimilate critical economic information dispersed among millions of persons and meaningful only through the market process.

During the 1970s, macroeconomic policy based on the assumption that government possessed the necessary information to fine tune the economy proved unsuccessful with rising rates of both inflation and unemployment. The prevailing notion of macroeconomic policy was simply defective. In particular, the idea of a stable, predictable trade-off between unemployment and inflation, embodied in the Phillips Curve and used to justify inflationary policy in the 1970s, broke down. Illustrating the point, inflation and unemployment have both declined during the current expansion.

Another milestone was recognized with the award of the Nobel Prize in economics to James Buchanan in 1986. According to the public choice theory he developed, public officials have neither the knowledge nor the ability to act free of political influence. As a result, in the absence of constitutional constraints, policy is to an extent driven by special interest pressures that were not always consistently in the public interest.

Figure 3.1 -- The Budget Deficit, in $billions



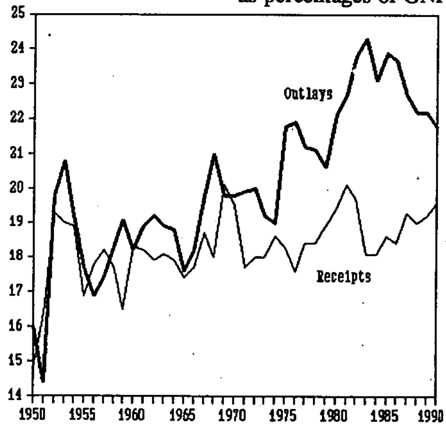
Source: CEA

Though Nobel Laureates Hayek and Buchanan are not widely known outside academic circles, their theoretical insights are reflected in the views of many citizens with respect to the role of government. Fewer believe that government can or should play the leading role in determining the direction of the economy. There is a broad consensus on the need for government in some areas, but there is also acknowledgement of the inherent limitations of government and the effectiveness of governmental solutions.

Consequently, the earlier concept of managing the economy by discretionary changes in budgeted outlays, revenues, and deficits has been virtually abandoned. As Buchanan argued, the unintended result of the earlier approach was the tacit acceptance of deficits by many government policymakers. This breakdown of the traditional taboo against deficits had removed a powerful constraint on the growth of federal spending. As Figure 3.2 below shows, federal outlays as a share of GNP trended upward in recent decades, but are moving down now.

Budgets and Budgeting

Figure 3.2 -- The Growth of Government, as percentages of GNP



Source: Fiscal Year 1991 Budget of the United States

Between 1980 and 1990 federal revenues will have grown by $556 billion, or 108 percent. Unfortunately, federal spending has gone up even more, leaving large deficits. In recent years, however, considerable progress has been made in reducing the size of the deficit relative to the economy. Currently, the deficit share of GNP is about 2.9 percent, roughly the same as it was in 1980, and about half of its 1983 post-recession level.

One reason for the persistence of deficits is procedural. Current budget practice assumes that federal spending is preordained to rise, and that any attempt to limit this increase is a budget "cut." As many have observed, no private institution uses this approach in budgeting: A rise in the level of their expenditures over the previous year is considered to be an increase. Moreover, a smaller than expected rise would not be described as a reduction in spending, as it is under current federal budget practice. This "current services baseline" approach to federal budgeting, which some have described as "Alice in Wonderland" accounting, should not be used in setting budget policy. The Republican Members of the JEC call for abandonment of this concept, as the Administration has urged.

The recognition that budget aggregates are not an effective macroeconomic tool to manipulate economic activity shifts the focus of budget policy. Instead, the allocation of budget outlays among specific programs and the cost-effectiveness of these programs in achieving their objectives will frame budget policy in the 1990s. In addition, there will be an urgent need to reexamine spending priorities in keeping with economic and social changes inside and outside the United States. An important challenge is posed by the size, timing, and use of potential defense savings, the "freedom dividend" arising from changing circumstances in the Soviet Union and Eastern Europe. In coming years these defense savings could help reduce the budget deficit, lower the tax burden on U.S. workers and companies, and accommodate some shift in spending priorities.

TAX POLICY FOR THE 1990s AND BEYOND

Just as the focus on the spending side of the budget will be shifting from manipulation of total spending to deciding on the priority and composition of that spending, the revenue side of the budget is undergoing a similar transition. Tax policy in coming years should be focused less on total revenues and more on the structure of the tax system.

Current U.S. tax law contains elements of both income taxation and consumption taxation. Even the "income" tax part of the system includes features more consistent with consumption tax concepts. For example, the income tax code contains many provisions, such as tax deferral on pensions, designed to reduce the effect of double taxation of saving and investment.

Under a pure income tax, the amount saved is taxed, and the subsequent return to such saving is taxed yet again. Yet the same amount, if consumed, is taxed only once since there is no monetary return. Thus, the income tax raises the price of saving relative to consumption, skewing tax policy.

In a free enterprise system, market forces guide consumption, saving, and investment decisions. In such an economic system, private saving and the accumulation of capital are the foundation of economic progress. The market-directed investment of additional capital will boost output and worker productivity, thus contributing to long-term economic growth and higher living standards. This beneficial result comes because private saving and investment rely on the guidance of profit and loss signals. The income tax code can distort these signals, creating a less efficient economy.

At a time when the importance of capital accumulation in the market economy is broadly acknowledged, U.S. tax policy retains many anti-capital features. Most of these features involve the multiple taxation of saving or investment. The simple case of double taxation of ordinary savings, already mentioned, undermines savings incentives for most Americans. In principle, this bias could be removed by making either the amount saved or the return to such saving, but not both, tax free.

Personal Saving

Various proposals have sought to accomplish this objective through expansion or modification of Individual Retirement Accounts (IRAs). For example, the Save America Tax Act provides that nondeductible contributions made to IRA-Plus accounts would accumulate interest tax free, so that qualifying withdrawals could be made without tax consequences (subject to certain rules). This increase in the after-tax rate of return would induce additional personal saving.

Because withdrawals could be made tax free, the structure of this incentive has been referred to as "back-ended" or "back-loaded," as opposed to the more conventional IRA tax incentive which offers a tax deduction "up-front." All else being equal, the two incentives offer identical tax incentives in economic terms; however, the back-loaded IRA would have the added advantage of avoiding potentially higher tax rates in the future, including the tax consequences triggered under the provisions of the social security benefits tax.

This year the President proposed a similar back-loaded tax incentive for savings called the Family Savings Account. This program would permit savers to save up to $2,500 annually (limited to two per family and income ceilings), with account earnings tax free so long as contributions remained in the account for at least seven years. This treatment would go a long way towards removing the double taxation of the personal saving of most Americans.

The precise impact of this tax incentive, like any similar policy change, is inherently uncertain and hence subject to debate. However, given the immense size of consumption relative to personal saving, even a slight shift in the direction of saving could substantially enlarge the pool of savings. For example, if only 2 percent of consumption were shifted to saving, the amount of personal saving would grow by 35 percent.

The Family Savings Account would offer a tax incentive similar to that provided in Japan for most of the postwar period. As Peter Drucker and others, including witnesses before the JEC, have pointed out, the Japanese policy of broad tax exemption for interest on savings was designed to avoid penalizing personal saving. Though there are other factors at work, tax policy has played an important role in the strong performance of Japanese saving. This, in turn, has helped foster the rapid growth of the Japanese economy.

Double Taxation of Dividends

Multiple taxation of corporate income is another aspect of the heavy taxation of income from saving and investment. Not only has the individual's original stock purchase been made from after-tax income, but any dividends will be taxed twice, once through the corporate income tax and once through the personal income tax. This illustrates the cascading effect of our multi-tiered tax system, in which saving and investment are stultified under layer upon layer of taxation. While each layer of tax does not appear all that heavy, the combined effect is detrimental.

As pointed out by many economists, repeal of the double taxation of dividends would remove the incentive to retain excessive earnings within corporations. This could be accomplished by making distributed dividends tax deductible at the corporate level, or exempt from tax at the individual level. If existing capital was made more mobile by reducing the taxes on its movement, the cost of capital would decline and capital would move to more efficient uses.

Capital Gains Taxation

An improvement in the prospect for future after-tax earnings is normally capitalized in the value of the income-generating asset, a corporate stock, for instance. The amount invested in this asset will ordinarily have been taxed as income, and the higher future income stream will be taxed under both the corporate and individual income tax. In other words, the income generating the gain has already been taxed multiple times. However, in the United States this capital gain is subjected to yet another layer of taxation when the asset is sold.

The negative impact of this tax on entrepreneurship, risk-taking, and capital accumulation by new, small firms is well established. Furthermore, according to testimony received by the JEC from a major forecasting firm, a cut in the capital gain will generate enough revenue to virtually break even over the long run. The United States taxes capital gains much more heavily than does most of her trading partners. The Japanese, for example, have taxed capital gains lightly for most of the last three decades.

Capital can be viewed as the physical and human tools available for production through saving and investment. Government policy which penalizes these activities is literally counterproductive and self-destructive. If the United States maintains a tax structure which attacks savings and capital formation, it will be crippling itself for the economic challenges of the next century.

CONCLUSION

The unsuccessful attempts to fine tune the economy by discretionary changes in budget aggregates have led to the widespread view that the focus of fiscal policy should be upon managing government programs and activities instead of trying to use the budget to manage the direction of the economy. Instead of trying to vary the level of total federal outlays, we should limit this aggregate to a relatively fixed percentage of GNP, such as 19 percent or 20 percent. While good policy and programs within the proper sphere of federal action can provide benefits, poorly conceived policy based on unrealistic assumptions will not. As we saw during the late 1970s and in 1980, the costs inflicted by policies designed to "manage" the economy can be quite large in terms of inflation, unemployment, and weak economic growth.

Over the last decade, the United States has been a world leader in implementing policies which rely on market forces to improve economic conditions. The sharp reduction in personal marginal tax rates, for example, has been emulated around the globe. Meanwhile, the intellectual respectability of socialism and government direction of the economy has collapsed in the wake of events in what used to be called the East bloc. The efficacy of state control has fallen under its own weight, while the prospects for democracy and capitalism have seldom appeared brighter. Though political pressures could still lead to serious errors in economic policy, few today believe that government is an end in itself, or capable of solving all social problems.

Section 4

ECONOMIC STATISTICSAND ECONOMIC POLICY

Democratic government responds most quickly to crises, whether real or imagined. Thus, justification for government action depends on a consensus that there is a serious problem for government to solve. The case for the existence of such problems relies very often on economic data.

Attempts are too often made to portray an aspect of the economy as much worse than it actually is. For example, in each year of the current economic expansion there have been urgent warnings of imminent catastrophe unless federal taxes and spending were significantly increased. These calls were resisted, and the longest peacetime expansion continues.

Another example involves the contention that the 1981 tax rate cuts did not spur investment. Real gross domestic investment has increased during the current expansion (see Figure 1.3), and has reached a high level of GNP by historical standards. The improved economic environment created by the 1981 reduction in marginal tax rates, and the reduction of inflation, created an attractive climate for domestic as well as foreign investment in the United States.

However, others cite the fact that net of depreciation, real investment levels look less impressive. This is true, but not necessarily relevant. As new investment has increasingly shifted to shorter lived equipment with more rapid depreciation, historical comparisons based on net investment figures have become less meaningful. An even more fundamental problem is that of accurately measuring the annual depreciation, or loss of productive value, of capital goods whose market values fluctuate widely.

More specific were the contentions that wealth concentration was increasing drastically, most of the new jobs were "bad" jobs, and the coastal regions were enjoying prosperity while the other parts of the Nation suffered. In due course, it turned out that wealth concentration data contained a $1 trillion error, that the economy is increasingly creating good quality jobs, and that the thesis of only bicoastal prosperity was based on a static analysis of a dynamic economy. Unfortunately, the residents of the northeastern United States experiencing an economic slowdown cannot take comfort in having the bicoastal thesis disproved.

The latest editions in the "create-a-problem" approach to government argue that the poor are getting poorer and that the income tax burden has shifted from the rich to the poor and middle class. Neither is true.

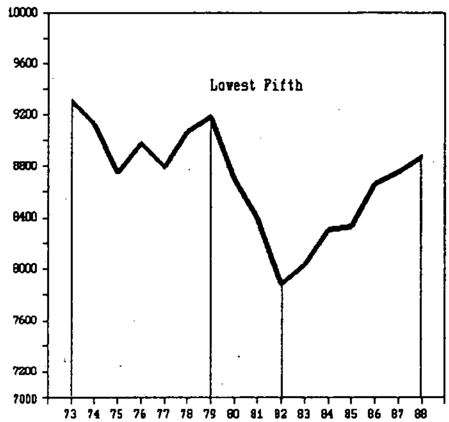
In the presentation that follows, we swim against the "create-a-problem" stream with regard to income and tax distributions, arguing that neither higher taxes nor increased redistribution is necessary.

POOR DOING BETTER

Economic data convey extremely important information, but precise measurement of even an apparently simple concept such as "income" is very hard to do. Aside from the data, there is the question of how they should be interpreted. This is often colored by political, social, and economic philosophy.

The level of family income is one primary determinant of family or household living standards. Official measurement of family income over time does not include the effects of non-cash income or government benefits, impact of the tax system, and several other factors. Nonetheless, families or households are typically grouped by level of money income into fifths ranging from low to high. These data can be arranged to show money income trends over most of the postwar period.

Figure 4.1 -- Income of Poor Rises, in real 1988 dollars



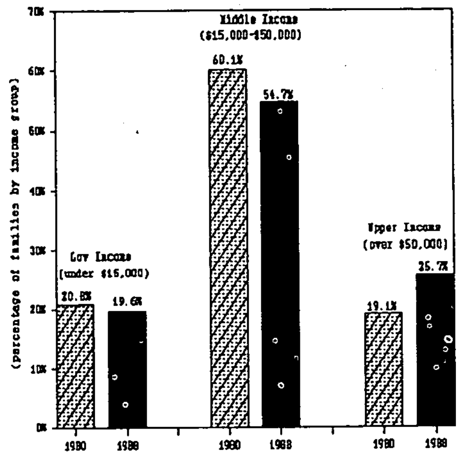
Source: Bureau of the Census

The choice of base years is critical in the portrayal of inflation-adjusted income trends. For example, Figure 4.1 shows how the level of average income of the bottom fifth of families has risen from $7,886 in 1982 to $8,880 in 1988, a real gain of 13 percent. However, in the stagflation and recession years following 1979 and continuing through 1982, the average income for this group dropped 14 percent, as the other fifths also experienced sharp declines. If the 1979 income level of $9,182 is used as a base, the statement can be made that between 1979 and 1988 income for the bottom fifth declined 3.3 percent (see graph). But the 1980 decline alone accounts for 158 percent of that 3.3 percent reduction. Because 1980 was an unusually negative year for income, it does not accurately represent the decade of the 1980s, which, for every income class, was one of income growth, not decline. Thus, income comparisons using 1979 as the base year are simply not meaningful. When income trends of the last decade are examined using any year other than 1979 as a base year, the average income of each fifth of families reflects gains.

The Ways and Means Committee recently released Congressional Budget Office (CBO) data which has led to reports that the real income of the bottom fifth of families declined 3.2 percent between 1980 and 1990. However, these data do not actually measure the changing levels of real income, but instead present the real income levels of quintiles as a percent of the poverty threshold. The real income of every quintile rose in the 1980s, and it is unfortunate that CBO has not corrected the public record more forcefully. It may be that real incomes grew less rapidly than the poverty threshold over the last decade, but, as Figure 4.1 shows, this was because of the fall in incomes in the first part of that period.

Looking at the situation in a different way, as income increased overall, the proportion of families below a low income threshold of $15,000 in real terms has declined while the proportion of families in the upper income range has increased. Figure 4.2 shows how income gains have affected the share of families grouped as low income, middle income, and upper income. Since 1980 the proportion of low income families has been reduced over a percentage point to 19.6 percent in 1988. The middle class is also shrinking, as income growth has pushed more of its members into the upper income group over the same period. The share of families earning over $50,000 in real terms has jumped from 19.1 percent in 1980 to 25.7 percent in 1988.

Figure 4.2 -- Percentage of Families With Low Income Declines, real 1988 dollars



Source: Bureau of the Census

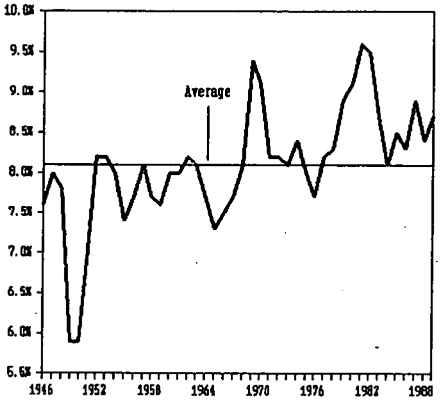
The income gains of the 1980s have not equaled the gains of the fastest income growth years in the postwar period. However, the trend during the current expansion has been much more favorable than that beginning in the late 1970s. Using the most appropriate inflation index, the 1988 level of median family income is a full $2,254 above that of 1973, cited by some as a peak year for income. The 1980s have witnessed a turnaround in family income that reflects the strong positive relationship between sustained economic growth and increases in living standards.

TRENDS IN PERSONAL INCOME TAXATION

One reason for the strong income gains for all income levels has been a productive change in the personal income tax system. Though personal income tax revenues are currently at record levels in both nominal and real terms, their ratio as a percentage of GNP offers another frame of reference. As Figure 4.3 below shows, this ratio has remained above the postwar average of 8.1 percent for most of the years since the late 1960s, but had gotten particularly out of balance in the inflation years of the late 1970s.

As Professors James Gwartney and Richard Stroup have pointed out, the tax system set in place under the Revenue Act of 1964 was radically transformed by subsequent inflation. The combination of the graduated tax schedule and inflation created the problem known as bracket creep.

Figure 4.3 -- Individual Income Tax,
as a percent of GNP

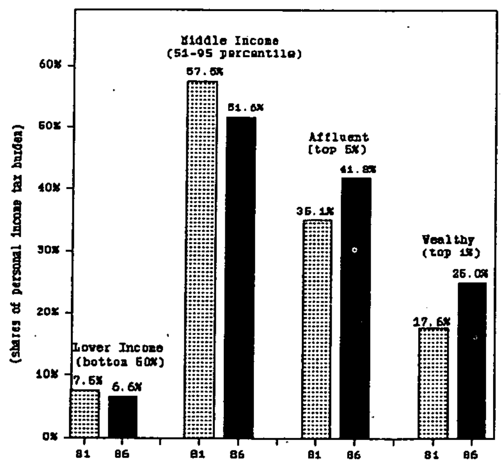


Source: Office of Management and Budget

As a result, tax rates previously reserved for the wealthy now were imposed upon a broad swath of middle class taxpayers. In the mid-1960s, only 2.7 percent of taxpayers confronted marginal tax rates at or above 28 percent; by 1980, 26 percent of taxpayers, all those with incomes over $23,600, found themselves in this situation. This higher tax burden is reflected in the graph, which shows the personal income tax share of GNP rising to 9.6 percent in 1981.

The tax legislation enacted in 1981 reduced individual tax rates over three years by 25 percent across the board, and indexed them to prevent future bracket creep, with the result that the personal income tax share of GNP returned to its postwar average. This ratio has trended upward from its 1984 level, and has continued to edge up under the 1986 tax reform act. Though somewhat higher than the average since 1945, personal tax revenues as a share of GNP were much closer to the postwar norm in the 1980s than during the late 1970s when inflation pushed tax rates upward.

Figure 4.4 -- Personal Income Tax Burden Shifted Towards Wealthy



Source: Internal Revenue Service

The tax rate reduction of the 1980s also resulted in a reallocation of the personal tax burden. The lower tax rates provided much less incentive to shelter income and engage in other tax avoidance activity. Consequently, the amount and share of personal taxes paid by upper income taxpayers increased sharply. As Figure 4.4 shows, the portion of total income taxes paid by the top 1 percent of taxpayers climbed from 17.6 percent in 1981 to 25.0 percent in 1986, the most recent data available.

As a result of this shift, the share of the personal income tax burden borne by middle income taxpayers dropped from 57.5 percent in 1981 to 51.6 percent in 1986. Meanwhile, the share of this tax paid by the lower half of taxpayers was reduced from 7.5 percent to 6.6 percent, as over four million left the tax rolls completely.

The data also show that the amount of personal income tax revenue contributed by the top 1 percent of taxpayers is nearly four times that derived from the entire lower half, a group 50 times as large. On average, the wealthy pay nearly 200 times as much income taxes as persons in the lower half.

Between 1981 and 1986, the average effective income tax rates of middle and lower income taxpayers declined by 15 percent. Meanwhile, effective tax rates paid by the top 1 percentile fell by 5 percent. Clearly, the effective tax rate reduction was largest for middle and lower income taxpayers.

The tax measures of the 1980s significantly reduced the actual and potential tax burden relative to the tax law in place in 1980. As a result of the 1981 legislation alone, the average family's annual income tax savings currently amounts to about $1,500, a sum partly but far from entirely offset by higher social security payroll taxes. To the extent the tax system as a whole has become more regressive for some taxpayers, this is primarily due to tax increases imposed outside of the personal income tax.

The social security tax legislation enacted in 1977 and accelerated in 1983 set the higher payroll tax rate American workers will face during the 1990s. To the extent the tax burden of lower income families has increased since 1983, this is entirely attributable to the acceleration of the higher payroll tax schedule under the 1983 social security legislation. Changes in the income tax could not result in higher tax payments for the bottom fifth of families simply because as a group they pay no income tax; as a whole their effective income tax rate has actually been negative. The payroll tax increase set under the 1977 Act and accelerated in 1983 has clearly increased the tax burden on middle income workers relative to what it would otherwise be.

CONCLUSION

As Jonathan Rauch wrote in last August's The Atlantic Monthly, "Never underestimate the ability of liberals and conservatives to overcome their agreements and argue to a standstill." Nevertheless, we look forward to ending the debate on income distribution and recognizing the common goal of growth in after-tax income for all segments of the population, and a continuation of the solid achievement in this area in the 1980s.

Section 5

THE NEW INTERNATIONAL ECONOMIC ENVIRONMENT

As the 1980s drew to a close, it became apparent that the countries of the Pacific Rim and Central and Eastern Europe, as well as many of the developing nations, have learned from the liberal, free market economic experience of the United States and Western Europe. With old theories of development economics and Marxist doctrine discredited, many of these nations have embarked upon growth-oriented economic programs aimed at controlling taxes and the size of government, relying on market prices, and creating a stable currency. While some nations continue to rely on foreign assistance, or adopt protectionist policies as a panacea for their economic woes, a growing number recognize that economic prosperity and self-sufficiency are most likely achieved through policies that encourage private enterprise and free trade.

For the United States, this new understanding of economic development around the world provides exciting opportunities for expanded, mutually beneficial trade and investment. As economic competition replaces military confrontation, the task for the United States in the 1990s will be to move energetically and innovatively into new markets around the globe, at the same time helping these economies move further in the direction of a market economy.

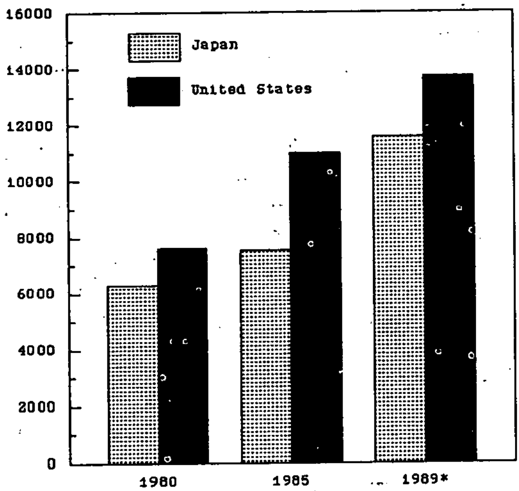
It is ironic that as the global economy grew and opportunities for U.S. business improved, many so-called experts were decrying the "decline" of America. The decline simply did not occur.

According to economist Herbert Stein, U.S. GNP is two and one-half times Japan's and five times Germany's. In both Japan and Germany, per capita GNP is only 75 percent of ours. Japanese workers produce in an hour what an American can produce in 31 minutes. In the 1980s, West Germany's annual growth rate was half that of the United States'. Japan's exceeded ours by a mere 0.7 percent.

Between 1970 and 1988, the U.S. share of the gross world product varied in a narrow range between 22 and 25 percent, and most recently was 24 percent. The United States continues to be the world's largest exporter. The U.S. share of world exports was 12 percent in 1970, 11 percent in 1988, and between 9 and 14 percent in the years between. In 1965, the United States accounted for 28 percent of world exports of technology-intensive products; this dropped to 23 percent in 1980 but rebounded to 26 percent in 1986.

THE PACIFIC RIM: AMERICA'S NEW FRONTIER

Figure 5.1 -- The Growing Japanese Consumer Market, per capita consumption in dollars



Source: DRI/McGraw-Hill & Economic Indicators
Note: Historical Exchange Rates
*1989 Projected for Japan

The rapid economic growth of Pacific Rim countries during the 1980s will lead to opportunities for the United States to sell to increasingly prosperous Asian consumers during the 1990s. The United States can renew and strengthen its role as a Pacific power and achieve greater prosperity and security through a strategy which both improves its productive capability and looks outward to growing overseas markets. American business would benefit by focusing more attention on the growing opportunities to sell to lucrative Asian markets. Rising income and consumption levels throughout the Pacific region are leading to a rising demand for consumer products and services.

A major factor in Asia's economic success has been the relatively unimpeded access of its exports to America's consumer markets. The United States expects no less from its Pacific trading partners. Improving market access to Asian markets and changing attitudes on the part of Asian consumers will lead to more economic opportunity for U.S. business as we move into the 1990s.

While government does play a role by helping to negotiate freer markets, the chief responsibility for devoting the time and resources necessary to penetrate Asian markets rests with each American and each U.S. company. Fostering competition is key. As George Gilder has pointed out, U.S. companies do well in international competition where there are more U.S. companies than Japanese (e.g. computers) and do less well where the Japanese have more companies competing. There is also a clear need for the United States to learn more about Asian cultures and languages. For example, of the Americans who studied abroad last year, only 5 percent studied in Asian countries.

While unilateral trade actions, such as Super 301 and the Structural Impediment's Initiative, provide a major outlet for government action, America's participation in regional organizations such as the Asian-Pacific Economic Council will over time foster an increased flow of trade, investment, and information in the Pacific Rim through constructive, multilateral means, the United States can play a key role in fostering the emergence of modern consumer-oriented societies in the Pacific Rim.

Finally, there is one thread which characterizes the economic success of Asia, the ability of Asian countries to save and invest for the future. While some have tried to attribute Asia's success to government planning, it has more likely been savings, investment, stable currencies, and hard work that have helped these economies prosper. The United States must increase its savings and investment levels which are critical for future productivity and economic growth. The productivity of the American worker is still the highest in the world, but we must save and invest more if we wish to keep it that way.

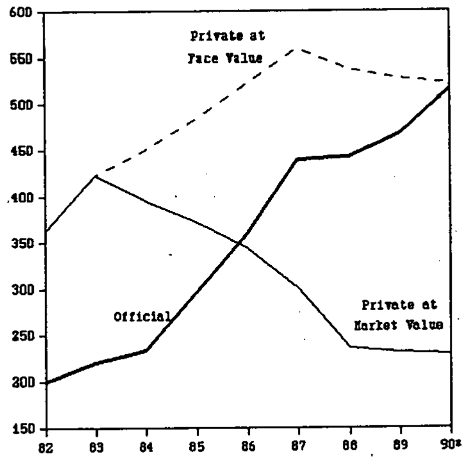
Thus, although America can learn from Asia's economic success, it should build on its own unique strengths: competition, flexibility, mobility, openness, immigration, resilience, and continual innovation.

A NEW POLICY FOR EASTERN EUROPE AND THE DEVELOPING NATIONS

The 1980s saw the disavowal of socialist economic development theories. The failure of inefficient government policies, as well as the impressive growth of the newly developed nations of the Pacific, highlighted the benefits of free enterprise over foreign aid and central planning. Policies of import substitution, foreign exchange controls, prohibitively high rates of taxation even at low income levels, and state ownership of industries had created huge and inefficient public sectors, distorted investment incentives, and limited trade in the developing world. Bilateral and multilateral grants and loans, rather than stimulating the economies of developing nations, led to further distortion of production and labor incentives and heavy indebtedness.

In addition to poor economic policies, the evolution during the 1980s toward free-market economics was restrained by the fact that indebtedness remained a major burden for many developing nations. Of particular concern is the fact that this debt is shifting rapidly away from commercial banks and into the Western public sector. Figure 5.2 shows the decline in value of the private sector's loans to developing countries. Discounts from face value were derived from Salomon Bros. index for the thin secondary market. Even with the assumption that market values have stabilized at 40 percent of book value, it is clear that the debt problem is rapidly shifting to Western governments.

Figure 5.2 – Official vs. Private Source Long-Term Debt, in $billions



Source: World Bank World Debt Tables
Note: See text regarding market value.
*Projected

Private financing has not only decreased in absolute magnitude and worth, but also relative to official aid. According to World Bank statistics, the portion of net resource flows to all developing countries provided by official sources grew from 37 percent of the total in 1981 to 63 percent in 1988. The dangers of moving debt into the public sector go beyond the increased risk to American and other Western taxpayers. While private lending is regulated by market forces which encourage productive investment of capital, government-to-government aid draws economic talent and decisionmaking out of the private, for-profit sector. Funds are often wasted on inefficient and costly state enterprises and on lengthy planning exercises. Furthermore, repayments to the International Monetary Fund, which provides short-term, high interest, non-reschedulable loans, has required growing financial outflows from developing nations.

The Eastern European revolution of 1989 demonstrated the triumph not only of democratic systems based on pluralism and rule of law, but also the importance of private enterprise in the pursuit of freedom and economic prosperity. The basic Marxist tenet that workers are a commodity exploited by owners and managers of capital was discredited when a labor union in Poland rose in opposition to the ruling communist party. Government after government in Central and Eastern Europe toppled as the facade of the "workers' state" crumbled. Over the previous seven decades, the Western world had proved that management and labor are not inevitably in conflict; in a democratic, technologically complex environment, the interests of the two often coincide. The greatest conflict in this century came from the exploitation of citizens by the state.

U.S. policy toward development in both Eastern Europe and the developing nations should be based on the idea that economic freedom -- property rights, market pricing, private enterprise, and free trade -- is the best way to promote economic growth and political stability. We have learned the difficult lesson that democracy is not viable without economic freedom, and that both must operate within an appropriate legal framework that guarantees fundamental liberties. We have also learned that, with the failure of socialism around the world, opportunities abound for international economic expansion through free enterprise and open trade.

As we begin to formulate policies in this new economic environment, it would be helpful for the U.S. and multilateral financial institutions to establish criteria for monitoring the progress and resoluteness of countries moving towards a market-based economy. The policies discussed in these Views are instructive: that high inflation cannot be tolerated and must be addressed with monetary policy; that currencies should not be undermined; that prices should be decided by markets rather than government controls; and that low tax rates are essential to growth. As free markets grow, Eastern Europe and the Soviet Union should avoid the debt trap and the developing nations must begin to climb out of it. Wherever possible, U.S. policy should rely on private investment, which creates inflows of capital, technology and management, rather than foreign assistance. Similarly, the United States should reduce its restrictions on imports from the developing world.

Development will also be enhanced by the influx of Western expertise in management, accounting, finance, and law. Management training and education will encourage the evolution of entrepreneurship and enterprise in developing nations.

Finally, both the new democracies and the West need to recognize that developing nations benefit from economic growth and prosperity in the West. Strong Western economies will improve trade opportunities, increase production, and lower debt service obligations. A healthy, growing U.S. economy that boldly meets the exciting challenges of the 1990s will lead to greater prosperity at home and in the emerging democracies of the world.

Section 6

THE GROWTH OF PENSION FUNDS

One thrust of the Minority Views is that the true economic policy challenges are in microeconomics, the study of how individuals, companies and markets react to their environment. We welcome the shift from looking for ways for the federal government to better "manage" the economy to government better managing its own programs, regulations, and tax policies. The bipartisan section of this Report has discussed several of these challenges: the environment, health policy, and employment and labor markets. The Minority Views have added market opportunities in the Pacific Rim, growth policies in Eastern Europe and the developing nations, and several aspects of tax policy to this review of microeconomic challenges.

One of the emerging issues in economic policy is the growing role of pension funds in the U.S. asset base. A JEC hearing last fall began a review of this topic, and this section presents some background data. As the topic develops, it will be important that we examine it not in terms of "managing" the economy or investment techniques, but instead in terms of understanding the way markets operate and the effect of government policies on market decisions.

There has been a dramatic change in the ownership of corporate America over the last 15 years. Institutional investors who control over $5.2 trillion worth of assets now own more than 42 percent of all publicly traded equities. The primary reason for this shift in control is the growth of public and private pension funds. These funds control over $2.3 trillion in assets, the largest pool of investable capital in the world.

Pension funds cover more than 56 million American workers and are expected to provide more retirement income than does social security by the year 2010. The payout of these funds will also represent a significant portion of national income, particularly when the baby-boom generation begins to retire in 2012. By 2020, pension fund payouts are projected to be over 6 percent of national income, compared to less than 2 percent in 1980.

Figure 6.1 -- Total Institutional Investors in 1988, in $billions

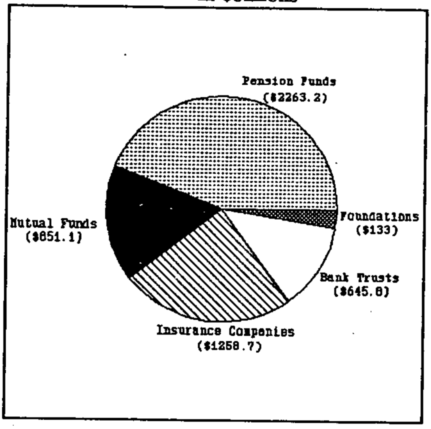
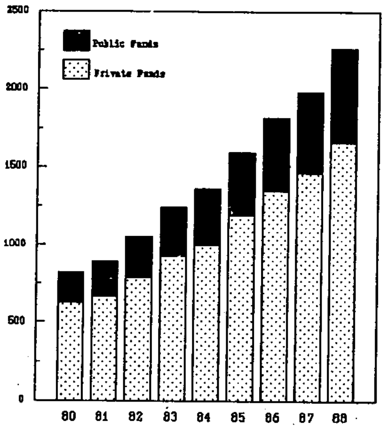
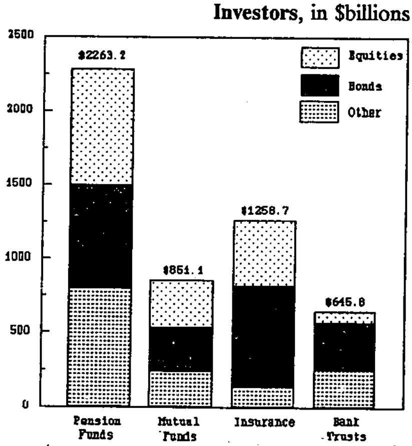


Figure 6.2 -- Growing Pension Fund Assets, in $billions



Source: EBRI Qtly Pension Investment Report/2nd Qtr 1989

Figure 6.3 -- 1988 Assets of Institutional Investors, in $billions



Source: EBRI Qtly Pension Investment Report/2nd Qtr 1989

Pension funds, which have tripled in size since 1979, own more than 25 percent of all corporate shares of U.S. companies. This unprecedented concentration of America's saving in the hands of a relatively few portfolio managers has created financial security for a growing number of Americans, yet raises policy issues as well.

One concern is that the build up of such large sums of money in pension funds is changing the nature of the financial markets. These funds might begin to be the market instead of investing in the market. Some believe that pension fund managers are too short-term oriented. A recent survey including 36 of the Nation's largest private pension funds concluded, however, that pension funds have a 38 percent yearly portfolio turnover, and on average hold stock for two and half years. Some have raised concerns that a proposal to tax short-term pension fund gains could actually lead to decreased liquidity and increased volatility in the stock market.

There are also questions on how pension fund managers vote their stock proxies to elect boards of directors and to approve buyouts or mergers. As their ownership increases, pension funds are beginning to exert increasing control in U.S. corporations. To some managers, such concentrations of ownership will seem threatening. Others may be able to take advantage of the availability of such large sources of investment capital. The policy goal should be to encourage both corporate managers and institutional investors to work together to seek the highest possible long-term return.

The huge stock market gains of the 1980s have created another issue -- should the corporation change the plan to share some of the gains of an overfunded pension plan with beneficiaries? Or should the managers be allowed to set up a new plan, using the excess in the old plan to grow, retire debt, or buy out owners?

It has been public policy for more than 70 years to encourage savings for retirement through pension funds. The special tax treatment of pension contributions is a widely accepted way to soften the double taxation of most other saving. The pension and retirement system seems to be working well and covers more than 25 percent of the U.S. population. The number and complexity of the issues raised above may be more indicative of the rapid growth and success of these plans, rather than the need for more regulation. Certainly, any change in public policy regarding our pension and retirement system would have complicated effects on our financial system and would require careful review and analysis.

ADDITIONAL VIEWS

REPRESENTATIVE CHALMERS P. WYLIE

I endorse both the *Bipartisan Report* and the *Minority Views* since they contain valuable, useful insights and are well written. However, I do have reservations about the general thrust of most paragraphs that compare the United Sates unfavorably with Japan.

We should guard against assuming the Japanese surplus in their trade balance with the United States is due to policies that favor investment in capital and saving over consumption. If we get distracted into advocating as good policy for the United States policies that the Japanese are using, and for that reason alone, we could be implementing measures to increase saving, investment, corporate research, and technological development and still find ourselves with a huge trade deficit in the year 2000. In the meantime, the Japanese could use the resources obtained from their surplus in merchandise trade with the United States of some $50 billion per year to buy our farms as well as our urban centers.

In short, I feel that both the *Bipartisan* and *Minority Views* are behind the curve of current thinking in the Congress and the Nation in matters of American-Japanese trade relations. Japan, Inc. exists in Japan just as surely as Wall Street exists in the United States. The difference is that we in America do a significantly better job of making sure Wall Street adheres to the rules of fair finance than the Japanese do in seeing that Japan, Inc. follows the international rules of fair trade.

For example, survey studies show that the Japanese consumers pay far higher prices for Japanese-made consumer goods in Japan than the same Japanese as tourists pay for the same Japanese-made products in the United States. (To be sure, one would expect transportation costs to raise such prices here to above the Japanese level.) This is dumping that is outlawed by the General Agreement on Tariffs and Trade under which, and only under which, we grant Japan so-called "most favored Nation" status, which means the lowest available tariffs for Japanese-made products. In short, the Japanese consumer is being fleeced, and the American producer is being dumped on by Japan, Inc. through their practices in international trade.

It is instructive to note that in those product lines in which so-called dumping and predatory pricing practices have already driven American manufacturers to abandon the market, such as camcorders and VCRs, the prices in the United States have risen back up to the levels that the Japanese consumers have to pay. This is exactly what monopolists are always tempted to do, which is why we in this country regulate monopolists, such as public utilities. Once the Japanese monopolists have a market cornered through unfair trade practices, such as dumping, they then raise prices and garner monopoly profits at the expense of both the American and Japanese consumers.

To the credit of the Japanese, many point out, and have pointed out for many years, that such actions are illegal under American law, and Americans are evidently reluctant to enforce our own laws against Japanese violations in the United States.

Many of us in the Congress expect the Administration to enforce our laws against the dumping of consumer goods in the American market at prices that are below the Japanese average cost of production, while charging Japanese consumers prices that are above the same average cost of production. Cornering American markets with short-run predatory prices to gain a long-run monopoly position from which to raise prices is illegal in this country, and it is illegal in international trade. There are sanctions for this lawlessness. The Administration should enforce the remedies the law already provides.

Many of us are alarmed at the extent to which the Japanese industry is closed to American investors. The experience of T. Boone Pickens and the Pickens Company is instructive. (See the *Wall Street Journal*, March 28, 1990, p. A13.) He and his backers initially bought about 20 percent of Koito Manufacturing Company, a supplier primarily of Toyota, the automobile manufacturing company. (They later increased their stake to about 26 percent.) Pickens then requested representation on the Board of Directors, and later, in writing, asked for the detailed financial records to which they are entitled under Japanese law. (See Japanese Commercial Code, article 293-6.) Neither have been allowed despite vigorous efforts by Pickens.

Those who say Americans have not tried hard enough usually do not take into account the so-called "keiretsu." A keiretsu is a formal, Japanese, interlocking-ownership conglomerate that has the effect of preventing representatives of American capital from participating in Japan, Inc. It does no good to say "try harder" if the keiretsu system blackballs me because I am American, or a foreigner to Japan. If we can't participate in Japan, Inc., why should the Japanese security firms be allowed to own seats on the New York Stock Exchange?

Many of us in the Congress believe that the Administration is confronting the reality of Japan, Inc. as a closed, secret monopolist, and we feel sure that the Administration will produce and implement effective, lawful sanctions to cure this problem. We urge them to persevere.

In the meantime, we call on the Congress to enforce and implement our own Gramm-Rudman law's requirements for federal budget deficit reduction, because we recognize that the federal deficit is at the core of a part of the trade deficit problem. For example, budget deficits have created borrowing requirements for the U.S. Treasury that are too large to be met with private domestic savings. The Treasury then has to go into the international markets to sell its securities, which, in practice, has made the United States dependent on Japanese savings and Japanese investors. Over the years, successive deficits, produced by the Congress, have come perilously close to making us a nation too dependent to take the forceful action needed to keep international trade and investment markets fair and honest. Japan must be more open to American business.

Chalmers P. Wylie

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CHALMERS P. WYLIE, M.C.

REPRESENTATIVE OLYMPIA J. SNOWE

While I am signing the *Joint Economic Committee's 1990 Annual Report*, I have also chosen to file some *Additional Views* on a few of the issues that the *Report* covers. In general, I agree with much of what it is said about the challenges this country is faced with in the future, although some of my own concerns regarding budget and tax matters and trade issues mentioned in the *Report* require further elaboration.

The *Report's Minority Views* mention the 1981 tax cut legislation several times. As I have stated in my *Views* from previous *Annual Reports*, the 1981 tax cut legislation was an important first step in the process of overhauling the federal tax code. The Economic Recovery Tax Act served as a foundation for the tax reform movement, which reached its culmination in the 1986 Tax Reform Act. As it has for several years now, the Congress should continue to closely monitor the impact that this comprehensive, multi-year tax legislation is having on low and middle income taxpayers.

As one method of increasing personal savings in the United States, the *Minority Views* express support for efforts to make personal savings, or the return on personal savings, tax-free. I fully share the concern expressed in the *Report* about the low personal savings rate and the need for more efficient uses of capital in America. If our economy is to continue growing, we will certainly need to address this issue. This is particularly true, in light of our continued dependence on foreign capital and investment.

I also wish to comment on several issues raised in the international trade sections of the *Bipartisan Report* and the *Minority Views*. I want to particularly address myself to the *Report's* sections regarding the government's role in increasing the ability of American companies to compete in the new international market and the need to ensure that our industries have free and fair access to foreign markets.

The *Bipartisan Report* mentions that much of the competition that domestic companies face is not based on unfair business practices or foreign subsidies, but rather upon the inability of U.S. firms to deal with aggressive international rivals. While I believe that U.S. firms must become more aggressive if they are to achieve success in the future, we cannot simply choose to overlook the numerous incidents and effects of unfair trade practices by our foreign trading competitors.

During my tenure in Congress, I have witnessed first-hand the impact of foreign subsidized goods and products upon domestic industries in Maine. The impact of lumber, shoe, potato, fish, and textile imports on Main businesses and workers and, more recently, the dumping of farmed salmon on domestic markets are just a few examples of how it has become increasingly difficult for American industries to survive, let alone compete, against subsidized competitors.

Similarly, the *Bipartisan Report* also denounces the use of trade barriers as a means of providing temporary relief from imports. The United States must differentiate between free and equal trade and that which is not. We cannot deny the reality of unfair foreign competition. I believe that help for beleaguered industries is sometimes necessary, and can, in fact, be effective in providing needed short-term relief from unreasonable import surges.

In the past, I have vigorously supported measures designed to achieve this objective. The Textile and Apparel Trade Act of 1988 sought to address foreign domination of the domestic footwear market that had reached an import level of 82 percent. This measure was needed, given the devastation that had been wrought upon domestic footwear producers by subsidized imports. In this specific instance, a trade policy that relegates American producers to only a 19 percent share of our own market cannot, and should not, be labeled unfair.

Recently, I have been encouraged by U.S. Trade Representative Carla Hills' stated intention to be more vigilant in monitoring and enforcing of existing trade laws and regulations. Our discussions with Japan on the Structural Impediments Initiative (SII) are positive signs that the United States is slowly, but surely, becoming more aggressive in pursuing fairness in global trade. The tools exist to achieve this goal, and they must be used to their fullest extent in order to provide our industries with a chance to gain access to foreign markets.

The *Report's Minority Views* offer some comments on our future trading relationships with pacific Rim countries. The inability of the United States to reduce its $50 billion trade deficit with Japan is certainly a priority; however, as I mentioned in my *Views* in last year's *Report,* our preoccupation with Japanese trade cannot obscure our equally important trade relationship with Europe.

We must ensure that a united European Community market in 1992 provides opportunities, not obstacles. Europe 1992 cannot be allowed to produce a "Fortress Europe" that competitively priced, high-quality American goods and products cannot penetrate.

In this respect, I should note that the United States needs to focus renewed attention towards promoting the sale of our goods and services abroad. Is it any wonder at all why we have some of the trade problems we do, when, in 1988, the United States spent $1.20 per capita on export promotion efforts, when Canada spent $21 per person? Surely, this is an area of our trade policy that needs to be vastly improved upon if we are to maintain and upgrade our international competitiveness.

The *Minority Views* in the *Report* also suggest that individual Americans and companies should bear the primary responsibility for gaining access to emerging, consumer-oriented societies in the Pacific Rim. It further suggests that the federal government should only play a limited role in developing these markets.

Certainly, U.S. firms must show initiative if they are to succeed in the international market. However, it is most definitely in our Nation's interest for the federal government to aggressively seek and exploit opportunities to open and develop new markets for U.S. products.

Although I opposed the U.S.-Canada Free Trade Agreement, primarily because it failed to address my concerns about Canadian subsidies for the potato, lumber and fishing industries, this bilateral agreement has been used to open up Canada's market in furniture, computer equipment, the service industries and manufactured finished products to American-made goods. It's simply unreasonable to expect our citizens and industries to do this job themselves.

The *Minority Views* also endorses the easing of restrictions on imports from developing nations. Again, we must be cautious about the impact of such policies on our domestic producers. The flood of Third World-produced footwear into the United States seriously damaged our own domestic industry, forcing factory closings and large scale work force reductions. For example, the State of Maine lost 19 plants and over 7,000 jobs as a result of unfairly subsidized foreign shoe imports.

In conclusion, international trade is evolving rapidly as new markets open and expand at an unprecedented rate. The success of the United States in this global marketplace is dependent upon the ability of our firms to seek and take advantage of new opportunities.

To this end, the government can, and should, use all of the tools currently available -- and develop new ones where necessary -- to foster the competitiveness of our industry. The government has taken some positive steps in this direction, but we must continue to be both vigilant and realistic in our dealings with our foreign competitors in the future. Our industries, and their workers, expect no less.

Olympia J. Snowe

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