S. Hrg. 103-279

THE 1993 ECONOMIC REPORT OF THE PRESIDENT

RINGS

BEFORE THE

JOINT ECONOMIC COMMITTEE
CONGRESS OF THE UNITED STATES

ONE HUNDRED THIRD CONGRESS

FIRST SESSION

PART 1

January 27 and February 11, 1993

Printed for the use of the Joint Economic Committee

76-207

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

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SUBMISSIONS FOR THE RECORD

THE 1993 ECONOMIC REPORT OF THE PRESIDENT: ECONOMIC OUTLOOK FOR 1993

WEDNESDAY, JANUARY 27, 1993

CONGRESS OF THE UNITED STATES,
JOINT ECONOMIC COMMITTEE,
Washington, DC.

The Committee met, pursuant to notice, at 10:00 a.m., in room 2237, Rayburn House Office Building, Honorable David R. Obey (Chairman of the Committee) presiding.

Present: Representatives Obey, Andrews, Armey, Saxton, Fish and Roth; and Senators Bingaman, Dorgan, Robb, Bennett and Craig.

Also present: Stephen A. Quick, executive director; William Buechner, Lee Price, Glen Rosselli, Donald Tobin and Christopher Frenze, professional staff members.

OPENING STATEMENT OF REPRESENTATIVE OBEY, CHAIRMAN

REPRESENTATIVE OBEY. If I could ask everyone to take their seats, please.

Let me simply say that the Committee is in the process of being organized for this coming Congress, and our new members are slowly but surely being appointed to the Committee. I should announce that I have just been told that Mr. Michel, the Republican Leader, has reappointed Mr. Armey from Texas and has appointed Mr. Saxton from New Jersey to the Committee, with two other appointments to be coming shortly. Frankly, I am not certain yet who the Speaker has appointed on the Democratic side of the House. And I assume our Senate colleagues will be joining us shortly.

On behalf of the Joint Economic Committee, I am pleased to welcome our distinguished witness this morning, the Chairman of the Board of Governors of the Federal Reserve System, Alan Greenspan.

The Committee is here this morning to examine the economic outlook for 1993, and in particular how the Federal Reserve can contribute to strengthening the economic growth in 1993 and beyond.

This country has just come through three nightmare years of recession, bare-bones growth, disappearing jobs and falling income. During the recession, which began in 1990, we lost more than 2 million payroll jobs and almost 10 million people were unemployed. Since March of 1991, in technical terms, we have been in what economists technically call a recovery. But during the past six quarters, the economy has grown at an average rate of 1.9 percent, less than one third the rate of average postwar recoveries.

That has not been enough to create jobs or put people back to work. We still have 9.3 million people unemployed. There are more people unemployed today after 21 months of recovery than there were at the worst point of every other postwar recession but one.

In the private sector, which this country depends on very largely for its economic strength, there are 1.4 million fewer federal payroll jobs than there were at the start of the recession. That situation at the current trends will persist at least two more years.

That is probably why only 34 percent of Americans feel that the United States is in a recovery, with 35 percent believing we are still in a recession and 27 percent believing that we are in a depression. They define the economy in terms of what is happening in their own lives, based upon what they see in their own real life experiences.

At the same time, on the other side of the ledger, the inflation situation now is in better shape than at any time during the past 25 years—the inflation rate was roughly 3 percent—except for 1986 when inflation was helped by a big drop in oil prices. You have to go back to 1965 to find a lower inflation rate than we had last year.

It is apparent that this country needs stronger job and economic growth. This Committee held a hearing on December 30 under then–Chairman Senator Sarbanes, at which point Professor Paul Samuelson at MIT, a Nobel Laureate in economics, and Professor Paul McCracken, who served on the President's Council of Economic Advisers under President Nixon, both testified that we needed roughly 4 percent growth in 1993, twice the growth we have gotten so far in this anemic recovery.

The *New York Times*, which is not necessarily an economic source, but nonetheless observed recently that we need 3.5 percent growth just to keep the unemployment rate from rising. And they said this:

> For three decades economists held to the rule that an annual growth rate of two-and-a-half to 3 percent for the American economy was sufficient to absorb nearly everyone seeking jobs and thus keep the unemployment rate steady. But now with companies shrinking staffs and reorganizing to become more competitive, economists think it will require more growth, perhaps more than 3.5 percent on average over the next two or three years, to maintain the same equilibrium. We need 3.5 percent growth just to tread water, and yet it has been almost four years since we have seen a quarter of growth that strong.

Our need for stronger growth is demonstrated, I would suggest, also by the fact that there is a very large number of firms which are expecting to reduce their work force in the coming year. The announcement by Sears of their plans to eliminate some 50,000 jobs is only the most recent example.

I think one of the most startling aspects of this problem is the fact that while the country is used to seeing weak firms lose significant numbers of jobs during recessionary periods, the country is not used to seeing massive job loss on the part of the crown jewels, or at least what we used to think of as being the crown jewels of the economy—corporations from IBM to General Motors to Sears to you name it. When I was growing up, those were household words. Those were the dynamos of the economy.

We are starting a new year with a new president, with a lot of new members of Congress from both political parties. That new president is committed to stronger growth. I think it is fair to say that we hope the Federal Reserve will have a very cooperative relationship with that new president.

Newspaper stories like the January 18 story in the *Times,* with the title "Clinton goes head-to-head with the Fed," if they are accurate are not very encouraging.

I was pleased to learn on Meet the Press this weekend, Mr. Greenspan, that you and Secretary of the Treasury Bentsen have met twice, so far, and plan to have weekly breakfast meetings. He hope those meetings do lead to close cooperation between the Administration and the Fed, and help lead to a reversal of the anemic performance we have had during the last three years.

The Committee is very pleased to have the Chairman of the Federal Reserve here with us today to discuss these issues. After I have asked Congressman Armey for whatever statement he would like to make, I will ask you to proceed.

OPENING STATEMENT OF REPRESENTATIVE ARMEY

Representative Armey. Thank you, Mr. Chairman.

Let me say, it is a great pleasure, Mr. Greenspan, to welcome you here this morning. I am going to have to retire early from this meeting in order to chair a Republican conference. So please understand that I only leave reluctantly to attend to other duties.

I am also here to note that no House members have been appointed to the Joint Economic Committee, nor has any organizational meeting of the committee yet occurred. In other words, the JEC has no House members. It is simply inappropriate for the Committee to be conducting business. This is yet another example of how much respect the Democrats pay to the rules of the House. We should wait for our House members to be named before holding hearings. As Jefferson argued, you must sit to sit.

This aside, I hope you would address the issue of Federal Reserve accountability this morning, Chairman Greenspan. The relationship of the Federal Reserve to the Congress has been the subject of much discussion and legislation in the last few years.

A number of bills have been introduced that have the effect of, if not the intent of, increasing congressional influence over Federal Reserve policymaking. The record suggests this would be a great mistake.

I believe we saw President Johnson and William Martin go through this circus at another time, and Martin was right and stood his ground.

Whatever may be said about the imperfections in Fed policy, there is every reason to believe that congressional meddling would only make the situation worse. After all, Congress has established a track record in exerting influence in the financial sector, and we know this influence was often exerted in improper ways.

Congress helped to create the half a trillion dollar S&L disaster that we are still cleaning up after. We should finish cleaning up this damage before leading the charge on the debacle of the financial services industry.

The task of implementing federal policy is going to be left to the Federal Reserve in coming years. Mr. Clinton, after falsely condemning the Republicans for raising taxes on the middle class, now is proposing to do exactly that, despite his promises to cut your taxes. Nevertheless, during the campaign, when Mr. Clinton stated his view that the Federal Reserve policy had been about right, in light of his statement, why all the recent Democrat Fed bashing? It would appear Democrats have so little confidence in their ever changing federal policy that this Administration needs a scapegoat once again.

A convenient whipping boy will be required. Chairman Greenspan, I don't envy you your new role in our government. And let me say personally, I have long since been arguing that there is too much tendency for fiscal policymakers to fail in their duty and then call on the Fed to do even more super heroic things to get the fat out of the fire that has been put in by fiscal policy carelessness. And I think the Fed is scapegoated far too much.

I fear, Mr. Chairman, that somebody is preparing a whipping post in your honor. I want you to know that I believe you will get far more blame than you deserve in the coming months. I will try at least to speak on behalf of a balanced, responsible fiscal and monetary policy. And I am very confident that the letdown is on the fiscal end.

Thank you, Mr. Chairman.

[The written opening statement of Representative Armey is on p. 49 of the Submissions:]

Representative Obey. I thank the gentlemen for his balanced and responsible statement.

Mr. Greenspan, I have been told that several other members have opening statements they would like to make. So I will ask your forbearance and ask them to proceed first.

Senator Sarbanes, please proceed.

OPENING STATEMENT OF SENATOR SARBANES, VICE CHAIRMAN

Senator Sarbanes. Thank you very much, Mr. Chairman.

I am very pleased to join with Congressman Obey in this hearing with the Chairman of the Board of Governors of the Federal Reserve, Alan Greenspan.

Mr. Chairman, last year was not a good year for American workers and their families. It started with unemployment at 7.1 percent, it ended with unemployment at 7.3 percent, and unemployment stayed above the 7 percent figure all year.

The average number of people unemployed each month was 9.4 million, which means that some 23 million people or more were jobless at least once sometime during the year.

In addition, there were more than a million people who were so discouraged by the lack of jobs that they simply gave up looking, plus over six million who worked at part-time jobs because they could not find full-time jobs. They wanted full-time, but they could only find part-time jobs.

According to the National Bureau of Economic Research, the economy has been in a technical recovery since March 1991. The GDP is rising, but only one third the rate of previous recoveries, and that is too slow to create jobs.

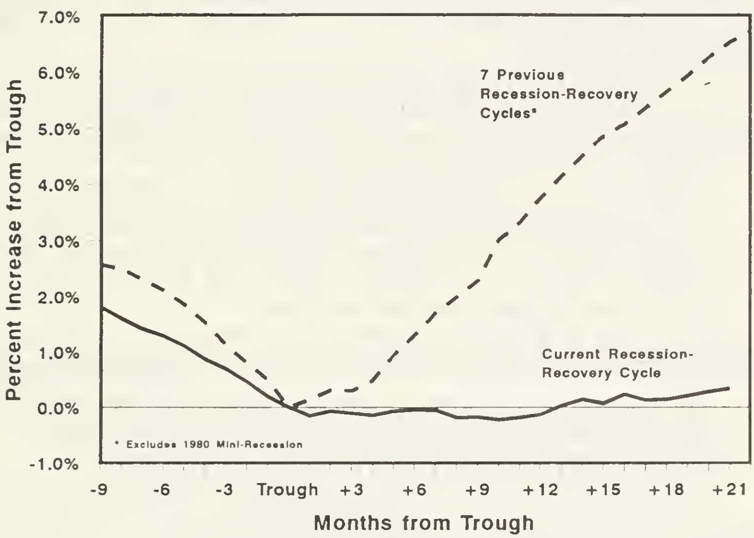
The unemployment rate for December, in fact, was five-tenths of 1 percentage point higher, higher than the unemployment rate at the recession trough in March of 1991.

While technically this may be a recovery, it is still very clear that we are in a jobs recession. And the movement on the economy in this recovery period is in marked contrast with previous recoveries.

I just want to just draw this contrast. This is the growth of payroll employment from the trough. Here is the trough. The green line here is the recovery, recession recovery cycle in the seven previous post-World War II recession recoveries. What we did, we went down in the trough and came out. We recovered all the jobs that had been lost and even more by this time in the recovery cycle. This time we are way down here. We have recovered about 20 percent of the jobs that have been lost. (See chart below.)

The Jobs Recession

Growth of Payroll Employment from Trough



Source: Bureau of Labor Statistics and Joint Economic Committee

This is a very marked discrepancy between what is going on this time and what has gone on previously. In my judgment, the principal economic task facing the country now is to achieve a rate of growth fast enough to make real and substantial progress on the jobs front. To achieve this, we will need economic policies which focus on strengthening the pace of recovery.

I have been very concerned recently that monetary policy may not be adequately supportive of recovery in the labor market. At the last meeting of the Federal Open Market Committee, the members of that committee indicated considerable support for a lower target for money supply growth in 1993.

And I am now quoting from the minutes:

> During the discussion, the members generally agreed that developments since mid-1992 had reinforced the case for some reduction in the 1993 range for M-2, and they indicated that they probably would support proposals for a lower range.

Lowering the target for money growth implies that the Fed is content with the anemic rate of growth that we have had so far in this recovery.

I find it incredible that the Fed would consider lowering its targets for monetary growth in light of the growing consensus among economists that slow growth of the money supply over the past several years has been a significant factor producing the current jobs recession.

In fact, for most of this year, money growth has failed to reach even the lower target range as set by the Fed. Since the trough of the recession, the real money supply has actually fallen in contrast to past recoveries when the Fed aggressively expanded the real money supply by a range of anywhere from 6 to 16 percent, thereby fostering much stronger economic growth.

Experts from both sides of the political spectrum across the range agree that money growth has been too slow, and monetary policy too tight, for much of the recent past.

On December 30, this Committee held a hearing on the conduct of monetary policy, and heard similar testimony from two of the nation's foremost economists. Professor Paul Samuelson of MIT, our first Nobel Prize Laureate in economics, told the committee, and I quote him:

> Monetary policy in 1992 missed an important opportunity to lean against the wind of a continuing American growth-recession. Economic history textbooks of the future will attribute George Bush's defeat and William Clinton's victory to Federal Reserve actions which from mid-1990 to mid-1992 were repeatedly too little and too late.

Professor Paul McCracken of the University of Michigan, a former Chairman of the President's Council of Economic Advisers, testified, and I quote:

> The management of U.S. monetary policy thus far in the 1990s will not go into the annals of central banking as a distinguished performance. It has been inappropriate for the economic conditions of the country.

I find no justification for a downward revision at this time in monetary targets. Inflation is both low and stable. There is no evidence of any impending acceleration. The inflation rate in 1992 was the lowest in the last 25 years but one. If anything, the current jobs recession and the current problems in the financial system argue for faster growth in the money supply, not slower.

Following the Fed's suggestion that we lower our targets would only compound the policy mistakes of the past, and condemn millions of Americans to continued unemployment.

It would be a sad irony indeed for the country to have voted to end the grid lock in economic policy between the Congress and the President, only to find it replaced with a new grid lock between an administration and the Congress committed to stronger growth and a Federal Reserve restraining growth by keeping its foot on the monetary breaks.

Thank you very much, Chairman Obey.

[The written opening statement of Senator Sarbanes is on p. 50 of the Submissions:]

Representative Obey. Mr. Saxton, please proceed.

OPENING STATEMENT OF REPRESENTATIVE SAXTON

Representative Saxton. Thank you, Mr. Chairman.

It is a pleasure and honor to be here this morning with you, Mr. Chairman, to hear your words of understanding about where we are relative to the economy. And I am sure you will touch on monetary policy and a number of other issues, which I will certainly be interested to hear about.

I hope in the context of your remarks that you will also remark relative to other managers of fiscal policy which operate here on the Hill. I have recently been privy to reading the results of one study, for example, which remarked in some length and in some depth about monetary policy as it is carried out here on Capitol Hill.

I just thought I would bring some of that information to your attention this morning in the hope that you might, during the context of your remarks, comment on it. This study covered a period beginning in 1965 through the current fiscal year, and it basically talked about growth in government spending as a percentage of GDP. It talked about growth in revenue as a percentage of GDP. And it talked about something that we heard a lot about in this political season, namely the growth in our deficit as a percentage of GDP.

It is remarkable that during that period of time our spending, as a percentage of GDP, has increased from 17.6 percent, according to this study, to 23.5 percent, or an increase in spending as a percentage of GDP of 33 percent.

At the same time, our revenue growth during that same period of time averaged 18.6 percent, not growth but as a percentage of GDP. Our revenue stayed roughly at that 18.6 percent, and as a matter of fact in the current fiscal year our revenue is 18.6 percent, by coincidence just the average as a percentage of gross domestic product. At the same time, our deficit grew from two-tenths of 1 percent to almost 5 percent, which is a fairly incredible and significant growth.

So, while our revenues remain fairly level as a percentage, our spending policies here on Capitol Hill increased by almost a third. I find those facts very interesting, and I am interested to know during your comments if you can comment on what you think that means.

I, Mr. Chairman, look forward to working as a member of this Committee, and in conjunction with the new administration. I have said over and over again that I would like to find places where, while I may disagree with some basic policies of the new administration, I look forward to finding places where we can work together.

And I remember very clearly during one of the debates when Mr. Clinton was asked by a reporter what you thought of the Fed policy, and he said, and I quote: "I think the Fed policy has been just about right." I am interested to know, based on your conversations with members of the administration, if that is still the case, or if this feeling that what the Fed has done is just about right may have changed on the part of this administration.

Mr. Chairman, thank you. That was a brief statement, but I appreciate again the opportunity to be here and look forward to hearing from you this morning, Mr. Chairman.

Representative Obey. Thank you.

Are there any other members that have brief comments before we hear from Mr. Greenspan?

Senator Bennett, please proceed.

OPENING STATEMENT OF SENATOR BENNETT

SENATOR BENNETT. I simply want to make a very brief comment as perhaps the newest member of the Committee.

Mr. Chairman, I heard you refer to Sears and IBM and General Motors, and saying that Americans are used to seeing weak firms fail or lay people off but not the crown jewels. I come to the Senate from an entrepreneurial background as the CEO of a company that started out with four employees, currently has a thousand, listed on the New York Stock Exchange and listed in *Fortune Magazine* as one of the country's fastest growing firms.

I have a firm conviction that in terms of their management strength, Sears, IBM, and General Motors could be challenged as weak firms, and that we cannot put all of the job loss at the feet of governmental policy, however convenient that may be. American management has a responsibility for some of the problems that we have.

It is my feeling, Mr. Greenspan, that the future of job growth in this country is going to be on the entrepreneurial side, and among the companies that are listed in the Inc. 500, rather than the companies that are listed in the Fortune 500. That is, it is the fastest growing part of our economy. And if you can address that, I would be very grateful.

I realize the parochial interest coming out of my background, and maybe the longer I am in the Senate I will leave that interest, but I felt I had to make that observation.

Thank you, Mr. Chairman, for the opportunity, and I am delighted to be on this Committee.

REPRESENTATIVE OBEY. Anyone else?

Mr. Greenspan, please proceed.

STATEMENT OF THE HONORABLE ALAN GREENSPAN, CHAIRMAN, BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

MR. GREENSPAN. Thank you very much, Mr. Chairman. It is a pleasure to be before this Committee, and I must say, this is the first time I have seen so many members, and I suspect that there is perhaps a renewed interest in economics, which I certainly hope is the case.

As you know, the Federal Reserve will submit its semiannual report on monetary policy to the Congress in just a few weeks, after our upcoming Federal Open Market Committee meeting. At that time, I will be in a position to address more specifically our expectations for economic growth and inflation, and the ranges of money and credit expansion that we anticipate to be consistent with the achievement of our goal of maintaining maximum sustainable growth in the economy, by fostering a stable, noninflationary, financial environment. Under the circumstances, my opening remarks this morning will focus primarily on identifying the major tendencies visible in our economy today.

The available data suggest that economic activity has been increasing at a firmer pace of late. After rising at only a 1.5 percent annual rate on average, over the first five quarters of the expansion, real gross domestic product increased at about a 3.5 percent rate in the third quarter of 1992.

The advance estimate of the Bureau of Economic Analysis of the fourth quarter's growth, which will be released tomorrow, is expected by many analysts to show a substantial gain as well. Meanwhile, industrial production posted a healthy advance over the final three months of 1992, with solid growth for a broad range of industries.

The recent news on the inflation front also has been quite favorable, as businesses have continued their efforts to contain production costs and boost efficiency.

Although a number of economic indicators are distinctly encouraging, this is not to say that we have clear sailing ahead. As I indicated when I appeared before this Committee last March, households and businesses have been struggling to redress structural imbalances unparalleled in the postwar world. The speculative bidding up of real estate and other asset prices over the course of the 1980s fostered an excessive accumulation of debt and assets. The subsequent weakening of asset prices in the early 1990s left the balance sheets of many households and businesses strained with debt overload. Banks and other intermediaries that had financed the buildup had suffered losses that had severely eroded capital. The pressures to work down debt, reinforced by understandably more conservative lending practices, slowed economic growth. Some time ago I likened these pressures to head winds of 50 miles an hour.

Those head winds have now slackened somewhat, but they have not disappeared. The process of balance sheet adjustment, while becoming less of a restraint on the economy, will doubtless be with us for some time. In addition, we are coping with a sizable retrenchment in the area of national defense. And, although U.S. domestic demand appears to be improving, many of our key trading partners are experiencing disappointing economic performance. This is acting as a drag on our exports and our output.

Much of the strength suggested by the incoming U.S. data has been in the consumer sector. The speedup in consumption comes after a period of more conservative spending behavior when many households seem to have focused on paying down debts and shoring up balance sheets so badly pressured by the events of recent years. The relative strength of spending, thus, may reflect the improvement that has been achieved to date in the financial health of households. Debt-to-income ratios have fallen slightly, and debt servicing burdens have declined quite noticeably, in large part because of the reduction in interest rates. At the same time, the value of household financial assets has been buoyed by the rise in stock prices last year. Moreover, concerns about housing prices, which probably were a key reason that consumers were so distressed for much of the past few years, seem to have lessened.

The strengthening of the housing market also may be important in a more specific way. Sales of single-family homes have picked up and when existing homes are sold, the capital gains that usually have accumulated over time can be realized. The buyer of the home typically takes out a mortgage greater than that paid off by the seller. The difference largely reflects the realized capital gain of the seller who receives unencumbered cash, only part of which is apparently added to a downpayment on a subsequent home purchase. Such cash provides the seller with additional liquid funds to spend on consumer goods and services.

History suggests that this is just what has been happening. The marked rise in existing home sales in recent months has added to households' purchasing power by enabling them to realize capital gains at an increasing rate, helping to fuel the growth in consumer spending. Homeowners also have an opportunity to liquefy capital gains when refinancing an existing mortgage, and refinancing surged in the latter part of 1992. Realized or liquefied capital gains are not taken account of in computation of the official saving rate, whose recent decline therefore probably overstates the drop in the flow of saving as perceived by households. However, unless home sales, mortgage refinancing, and the associated equity extraction continue to rise, there is a limit to how much longer this factor can fuel the growth of consumer spending. The measured personal saving rate is at a relatively low level, and further outsized increases in consumption are not very likely in the absence of a sustained pickup in the income growth.

Consequently, a significant consideration in terms of the outlook for consumer demand is the employment picture. The optimism revealed in the recent surveys of consumer attitudes may prove fleeting if overall labor market conditions remain subdued. Indeed, despite signs of modest improvement in the past few months, since the recession trough in March 1991, employment has shown essentially no net change on a payroll basis, and only a modest increase in the household series.

Of course, the softness in employment in the current expansion is partly the counterpart of another development—namely, a dramatic improvement in productivity. Since the recession ended in early 1991, productivity has grown at an average annual rate of about 2.5 percent, a better than expected performance given the relatively slow pace of the economic recovery to date.

The corporate restructuring and downsizing efforts that have been associated with the recent productivity gains have in part been a response to the profit squeeze that emerged during the 1990-91 recession. They also have been spurred by increasing costs of health insurance and other fringe benefits, which have restrained hiring and encouraged a surge in the use of temporary workers. But restructuring also seems to have reflected an effort to capitalize on new opportunities for greater efficiency. Although we cannot be sure how or why these opportunities have arisen, I suspect they are the product of the accelerating advances in computer software and applications. Past large accumulations of computer hardware did not seem to have the expected effects on productivity. But a new synergy of hardware and software applications may finally be showing through in a significant increase in labor productivity.

These far-reaching changes in the production processes in manufacturing and in the means by which services are produced and distributed have apparently yet to run their course, though one must assume that the pace of restructuring will surely slow. Accordingly, we may see less of a tapering off in productivity gains in coming quarters than past cyclical experience would suggest. That prospect is highly favorable in terms of the longer run potential output of the economy and our international competitiveness, but it also implies some continuing adjustments in the work force in the near term.

The push to acquire state-of-the-art technology has also provided a discernible thrust to capital spending in recent quarters—and likely will continue doing so. Real outlays for office and computing equipment have soared as firms continue the transition to the more powerful and cost-effective machines that are now available, and purchases of communications equipment continue to be boosted by, among other things, the shift to fiber-optic networks. Demand for other, more traditional types of equipment now appears to be growing as well. The improved pace of economic expansion has doubtless lifted sales expectations, and the marked increases in profits and cash flow over the past year are providing funds for the new purchases.

Problems, however, remain in a number of areas, though with some lessening of concern. Chief among them are the ongoing difficulties in the credit area. Depressed demand is doubtless the major explanation for weak loan growth at banks and many other intermediaries. However, increased regulation presumably has also played a role. Moreover, lenders seeking to protect their capital positions have been extremely cautious. Although they seem to have stopped tightening credit terms, a significant easing is not yet evident.

Commercial real estate has accounted for much of the asset quality problems at financial institutions. Until real estate values clearly stabilize, banks and other intermediaries are not apt to become substantially more eager lenders. The liquidity of real estate markets remains impaired, and lenders are uncertain about the value of collateral and the appropriate level of reserves against nonperforming loans. The risk that further reserving may be necessary has led banks to bolster book capital, widen lending margins, and approach new credits with caution. It is not necessary for real estate values to rise to reduce this risk, but lenders need to be more confident that prices will not continue to fall and that, if necessary, they can sell collateral expeditiously at reasonably predictable prices. While there are some initial signs that commercial real estate markets in some regions are finding a bottom, uncertainty remains high. Having accumulated substantial liquid assets and rebuilt capital, banks seem well positioned to meet increased loan demand, especially once collateral uncertainty diminishes. Endeavors by both the Resolution Trust Corporation and private parties to encourage the development of a secondary market in commercial mortgages will help liquefy the market in commercial real estate itself. However, should problems in commercial real estate persist, credit conditions for small and riskier business may ease only gradually for some time.

Soft property prices, engendered by high vacancy rates and sluggish demand for space, are likely to continue to restrain commercial construction spending in 1993, and the prospects for multifamily housing are not much better. In addition, budgetary pressures on state and local governments remain intense.

Meanwhile, we must continue to work through the sizable adjustment in military spending that has been under way since the late 1980s. From a longer run perspective, the defense cutbacks carry the anticipation of substantial benefits for the U.S. economy.

Many of the countries of continental Europe and Japan have recorded only weak growth. And in Canada and the United Kingdom, signs of recovery from prolonged recession have ranged between weak and elusive. Our export performance is thus being restrained by the developments abroad.

We at the Federal Reserve are seeking to foster financial conditions that will encourage maximum, sustainable growth in the economy. As I and my colleagues have stressed, a noninflationary environment is a precondition to such a goal. For the coming year we will continue playing a constructive role in supporting an extension of the recent, more hopeful signs of solid growth, while endeavoring to avoid any excesses that might lead to a flare-up of inflationary pressures down the road.

Such a course will help the economy emerge from the financial difficulties of recent years, maintain the progress toward price stability that has been achieved thus far, and thereby promote a sustainable economic expansion.

Mr. Chairman, I have excerpted from my full remarks, and request that the full testimony appear for the record.

Representative Obey. Surely.

[The prepared statement of The Honorable Mr. Greenspan, along with an attachment, is on p. 52 of the Submissions:]

Representative Obey. Thank you very much.

Let me say, Mr. Greenspan, that given the earlier remarks which created the specter of a fearsome round of Fed bashing, let me simply say that I don't really think that the public is interested in Fed bashing, Congress bashing, Republican bashing, or Democrat bashing. I think what they are concerned about is the fact that they feel bashed. And they expect all of their officials, elected and nonelected, to cooperate in designing a program to cease that bashing over time.

And I want to be very frank. I think what you have now is a situation in which one party, my party, has been put in control of the Presidency and the Congress. The public now expects us to produce, and they expect, and they believe, that we are in full charge of the levers of government. But as you full well know, that is not quite so, because under our system of independence for the Federal Reserve—a system which by and large stood this country in good stead over the years—the Federal Reserve has tremendous power through its monetary actions to either facilitate or to lean against and to some extent to block or cancel out policy actions made by elected representatives in the Legislative and Executive Branches of government.

I believe in the principle of Fed independence to prevent the elected officials from catering to irresponsible fiscal and spending pressures. But I also believe that the Fed has a concurrent responsibility to respond to legitimate public demands for policy changes, just as we have that responsibility.

Elections are supposed to not just replace people, but are supposed to send messages from the public to us. I think the public has a right to expect that as the old gridlock between the President and Congress slowly dissolves—I hope rapidly dissolves—it is not replaced by a new gridlock between elected political leaders and nonelected economic leaders in the country.

And that is why we want to seek responsible cooperation in pursuit of an economic policy. And, I think, speaking very frankly, the problem is, and it is partly by design, as you know, the problem is that there is a lot of uncertainty on the part of members of Congress as to exactly what a Fed policy can be expected to be in the next very crucial period.

As Senator Sarbanes pointed out and as I pointed out in my opening statement, in a recent hearing before the Committee, a witness pointed out that because of rapid productivity growth—growth which you have mentioned in your statement—the economy needs to grow at close to a 4 percent rate to reduce unemployment from the 7 percent plus level which we are now experiencing.

Yet, Paul Samuelson voiced concern in that hearing that if growth hit 3 percent or better, the Fed would probably allow interest rates to rise and squeeze the money supply. Paul McCracken expressed concern that you would "be fighting the last war" against inflation, despite the fact that it is 1 percent lower than it was the previous year, and despite the fact that it is at historic lows with the exception of the one-year period that I have referred to in my opening statement, that you would be fighting that war rather than helping to boost growth.

And, frankly, there is some concern that you would be pursuing a policy that is primarily aimed at bringing us closer to zero inflation, rather than making sufficient room for moderate efforts to increase prospects of growth on the part of the Administration, and that we would therefore be condemning the country to continued high unemployment, to sluggish income growth, and to reduced investment.

Can you assure us, because what I am very much concerned about is the word on the very last page of your statement, when you said that a noninflationary environment is a precondition to the goals that you were talking about.

And that word "precondition" can have various meanings. Some people are afraid that that means that you are really determined to bring us much more close to zero inflation before the Fed accommodates any effort to attack the sluggish growth in the economy.

And so, I guess, I would simply ask you, can you assure us that you are going to be taking a more balanced approach than that? Can you assure us that Samuelson and McCracken are wrong in their evaluation of your intent so that we can have some degree of confidence that we will in fact have a cooperative relationship between the administration policy and yours?

Mr. Greenspan. Mr. Chairman, let me just say first that cooperation is already accelerating between myself and other members of the Federal Reserve Board and the new Administration. I have met with a number of the people in the Treasury Department, for example, and obviously Secretary Bentsen. Indeed, I had breakfast with Secretary Bentsen this morning. And we are discussing a variety of different elements about the economic outlook, both domestically and internationally, and have pledged to coordinate our views and systems as best we can.

As far as I can judge, the general thrust of the policy of this Administration is not different from that which I expressed in my prepared remarks. That is, to promote maximum sustainable growth over the longer run.

And the reason I raise the issue of a noninflationary environment is that what we do not want to do is get into the stop/go type of instabilities which have so characterized many of our periods in the past. Neither we nor President Clinton would basically subscribe to that view.

Now, when we get to the question of how does one implement that goal, it obviously becomes an extremely difficult problem, because we are in fact dealing with a period without precedent in the post-World War II period. As I indicated in my prepared remarks, this has been an extraordinary period, and one in which the usual processes of business cycle resolution have been absent. And one need only look at the chart that Senator Sarbanes just showed to give an indication of how different this particular phenomenon is.

When one looks at the productivity data and the restructuring that is going on and the reshuffling of the whole system, it is really quite an extraordinarily different type of economy than we have seen in a very long time. Indeed, it is the first time in my experience, which goes back several decades, that I have seen anything like this.

And so it is incumbent upon the Federal Reserve and the Administration to recognize that this is a different animal—and indeed, we all do—and to try and find the appropriate policies which in fact achieve the goal of maximum sustainable economic growth.

I might just say parenthetically, with respect to the quotations of what our policy has been, there are a very substantial number of economists—those of all persuasions, I might add—who think that we have been too easy. There is, as you know, an organization called the Shadow Open Market Committee, which basically follows the Fed very closely and has a number of distinguished economists who have in fact been claiming that because the adjusted monetary base, which mainly includes reserves and currency, has been accelerating at a rate which would destabilize the economy.

Now, we don't agree with that. But I must say, we also don't agree with the view that the appropriate money supply measure, or more exactly, the appropriate measure of financial conditions of the last two or three years is our measure of M2.

What we do believe is that there is an extraordinary set of changes that are going on which has made it very difficult to trace the processes of money and credit in our system. And on the basis of fairly detailed analysis, we have concluded that the changes that have occurred of late in M2 have temporarily, hopefully temporarily, created that problem.

Representative Obey. If I could interrupt, because my time is almost up, I guess what I am asking, and I would still like you to respond to it directly, if you would, do you believe that if this economy were to in fact grow in the 4 percent range in the coming year, in real terms, would that be too rapid to fit your definition of sustainable growth?

Mr. Greenspan. I don't think one can make the judgment by looking at the growth rate by itself. You have to look at the collateral events that are occurring with it.

I would say more importantly, we would be looking at the financial system and whether or not credit growth is accelerating at an unsustainable rate, or that the balance sheets are beginning to evolve in a way which would become unsustainable. But specifically looking at the real growth rate per se, I don't think is appropriate. That is, to answer your question very specifically, if productivity is rising significantly, and if the economy is moving in a manner which is not destabilizing, I can't say that there is any growth rate which I particularly think is inappropriate.

Indeed, I would like to see the maximum sustainable growth rate, and that is what we will endeavor to be supportive of, as best we can.

Representative Obey. My time is up. I would simply say that I would agree with you that we have to take a look at a number of factors in the environment to determine what policy ought to be. And I guess I would just point out again what some of those other factors appear to be, at least to me. I don't want to clunk anybody in the head here, but as you can see, this obviously demonstrates a very different growth pattern, this time versus other previous recessionary recovery periods, in terms of employment.

We also, in terms of growth, in M2 real——

MR. GREENSPAN. If I may interrupt just for a moment. While the employment picture is an important issue, because of a technical problem that exists in measuring M2, I would say that that particular indication of what is going on in the financial system is somewhat distorted.

REPRESENTATIVE OBEY. Well, it is possible that that may be so, but nonetheless it certainly doesn't look like M2 is pressing on the upside at this moment.

MR. GREENSPAN. I will also grant, if you had red on the upside and green on the downside, it would look different.

REPRESENTATIVE OBEY. Another one of the factors that we hope you keep in mind is simply that this is the comparison of real growth in the economy during this period versus other previous recession periods, or recession-recovery periods. As you can see, 1.9 percent is considerably slower than the recovery for other periods.

Senator Sarbanes has often used this chart to show what has happened on the job front, the green line representing what has happened to the creation of new jobs coming out of the recession for the average of previous recessions versus what is happening today.

There is a variation of that, which I noted appeared in, I think, one of my least favorite magazines, which indicated the variation in a little different way, the recovery that began on November 1982 resulted in this trend line in terms of job creation, very high, some 21 months out, over six million new jobs created.

In March 1995, almost four million new jobs created. And as you can see, minimal job creation here. So I think you can understand why we are concerned.

MR. GREENSPAN. That describes the dilemma that has been occurring in this economy and in this recovery very well.

REPRESENTATIVE OBEY. I am sorry to take more than my time.

Congressman Saxton, please take your turn.

REPRESENTATIVE SAXTON. Mr. Chairman, I was interested in those charts because I have some that look similar to the ones that I have used in trying to explain my perspective—what I know about the economy—and I am interested in your response.

I was particularly taken by the chart that Chairman Obey showed us, which showed the difference between the economic growth that has taken place in this recovery as opposed to the 1982 recovery. There is a tremendous difference in the fiscal policy as set by the House and the Senate in the early 1980s and in 1990.

In 1981, 1982, and 1983, we set in force, before I got here, some fiscal policy that was intended to propel growth. In 1990, we passed the Budget Reconciliation Act, which in my view, contrary to what other people may have thought, was going to severely limit growth.

And so, while Chairman Volcker and Chairman Greenspan have a similar job to do, they certainly have a different economic atmosphere in which to do the job. So the policies as set forth by the Fed today may be blamed for slow economic growth by some, and by some others we may look at Capitol Hill and at the economic policy that we put in place, which is certainly different than it was at the inception of the growth line in 1982. I would just be interested in your response to that different perspective.

Mr. Greenspan. Congressman, I must say that the causes of the recession of 1990 and 1991 were the subject of a panel at the American Economic Association a number of weeks ago, and the general conclusion, if one can say that that was possible among a group of economists, is that it was very difficult to judge.

The major conclusion that did emerge was that there seemed to be a spontaneous reduction in consumer spending, and that neither monetary nor fiscal policy appeared in the evaluation of most of the people who were talking on this particular subject. And I do think that the issues you raise are ones which, in retrospect, evaluators of business cycles and economic trends are going to be looking at somewhat closely.

And I say, from this perspective, it is probably too soon to fully know precisely how it will come out, because we haven't yet fully seen the development of this particular cycle. It is only when we see how this cycle works its way through that we will get a better perspective on both those periods.

Representative Saxton. I thank you for that very clear response, and I didn't mean that to sound facetious. Your job is a difficult one—and some would say ours is too—in your formulation of what the Fed is going to do relative to monetary policy.

At any given time, you certainly have a number of factors to take into consideration. Some are national in nature, some have to do with world trade, some have to do with the economies of other countries, some have to do with the performance and growth of the economy around the world, and a lot have to do with domestic issues, a lot have to do with—as you very well stated earlier—the consumer expectation of what consumerism ought to be based on, what individuals and the economy are thinking and all of those things together, the desire to buy homes or the lack of it. How do you factor all of those elements together and then put it together again with what we mentioned before— fiscal policy established by the House of Representatives and the Senate and the Administration? That must be a tremendous undertaking, to factor all of those things together.

Mr. Greenspan. It is, and regrettably we don't have what seemed to be the type of stable set of relationships which enabled economists to think that we could, perhaps, with some degree of the hope rather than reality, to make judgments of the appropriate balances of fiscal and monetary policy, with relatively simple analyses.

Indeed, in the early part of the post-World War II period, econometric models were developed, which seemed to work fairly well for a while, and gave us a fairly good judgment as to the structure of forces that were engendering how the economy behaved, and therefore how both monetary and fiscal policy would both function in a manner to contribute to the maximum economic and employment growth.

That clearly has broken down to a large extent, and the nature of the changes that are going on has meant that the type of economic structure, the set of forces which are driving this economy today, and the world at large, is somewhat similar to the past, but enough different that we have to struggle to find what those relationships are, sometimes very crudely, sometimes inaccurately.

And what we are hoping to be able to do is to find a structure in which we can hopefully sense that we know why these various connections are occurring and be able, basically, to get a sense of the appropriate policies that will create maximum sustainable growth.

What we do now is to look at an extraordinarily wide variety of things and try to essentially judge how the financial and economic systems are interfacing, and it is that which drives our policy.

Representative Saxton. Mr. Chairman, I am told my time has expired, but I would just like to conclude with one instance—which sums up what I have tried to say in my questioning—which is to demonstrate that while the Fed is certainly an integral and important part of our national, fiscal and regulatory system that makes things happen, positive or negative, it is only a part, and what we do on Capitol Hill is also a part, and an important one. And what happens around the world is a part, and an important part, and the domestic factors that play their roles are important elements as well.

So I thank you for your responses and your explanations, and I look forward to talking with you further, perhaps, a little later.

Mr. Greenspan. Thank you.

Representative Obey. Senator Sarbanes, please proceed.

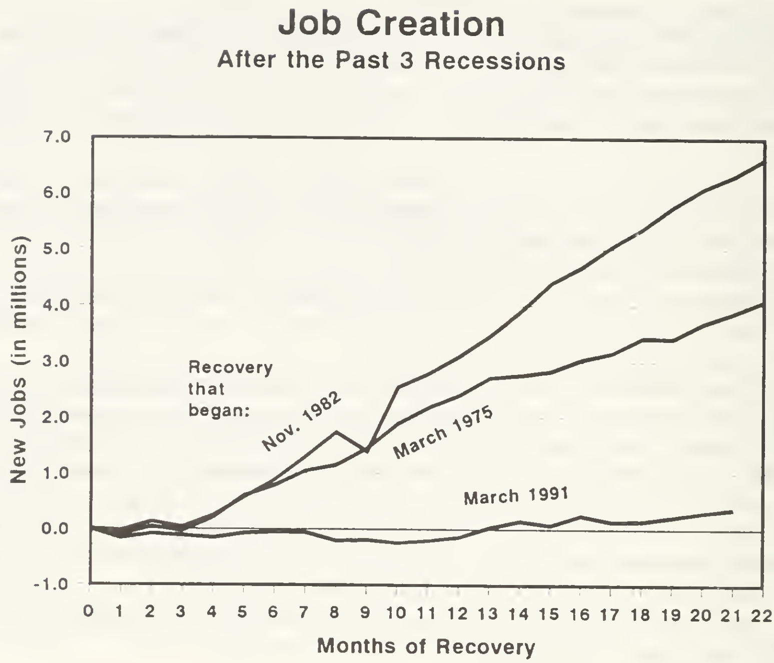
Senator Sarbanes. Thank you very much, Mr. Chairman.

Chairman Greenspan, welcome to the 103rd Congress. We look forward to seeing a lot of you in the next few weeks. When is the Open Market Committee going to meet?

Mr. Greenspan. Next Tuesday and Wednesday.

Senator Sarbanes. Good. I am pleased you are here today.

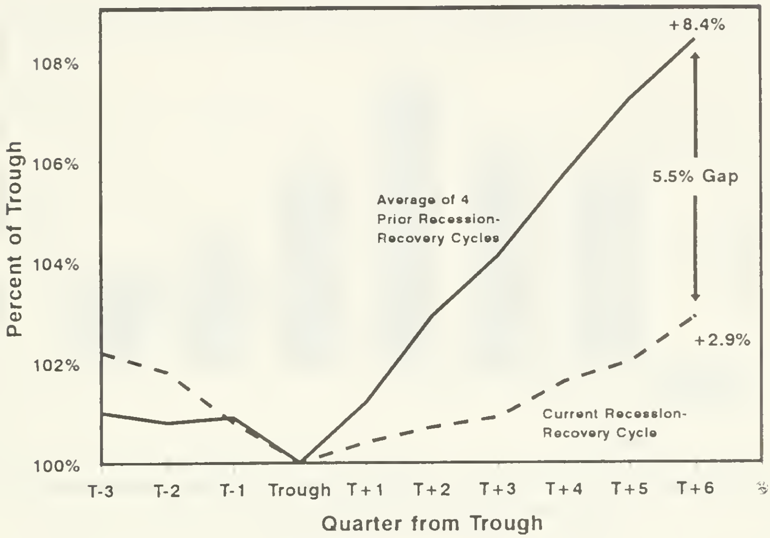
To lay the predicate for my questioning, I want to very quickly go through a series of charts. You have seen some of them, but I want to lay a couple of others out too. The first one is on the jobs recession, and the extraordinary contrast between the lack of recovery in terms of jobs in this recession, compared with other recessions in the postwar period. (See chart below).



Source: Bureau of Labor Statistics, Joint Economic Committee

And I have a comparable chart on GNP growth, which again, we had 8.4 percent average on growth, 2.9 percent thus far in this recovery, so there is a very marked gap there. Of course, that gap is reflected in terms of what is happening in jobs, and as we can see this recovery is weak and anemic on the jobs. We still have a jobs recession; we are not putting people back to work, and I don't think anyone can really contest that, compared with what happened in previous recessions. (See chart below).

Growth of Real Gross Domestic Product
Following Post-War Recessions



Source. U.S. Department of Commerce, Joint Economic Committee

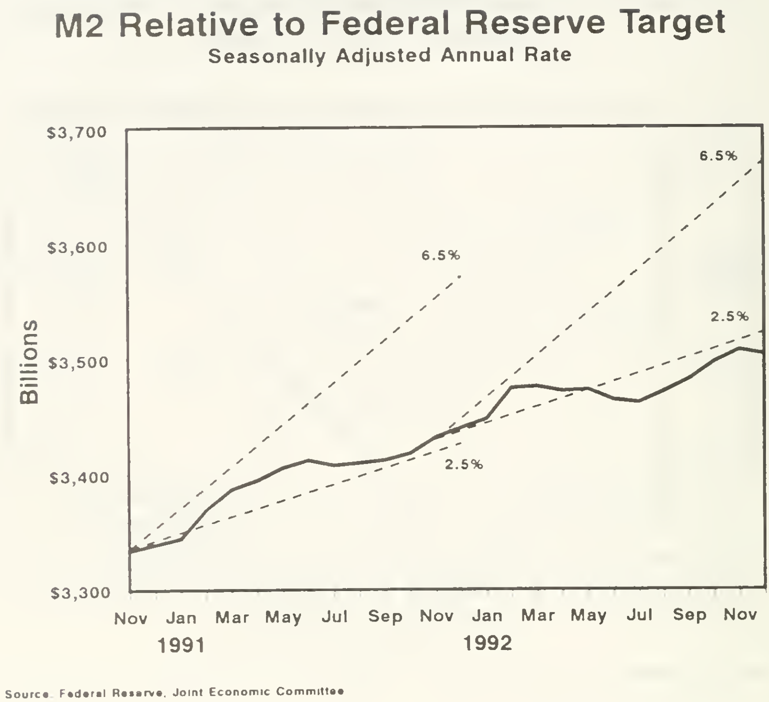
Now, the Federal Open Market Committee made projections about the unemployment rate last year. This was your range. Of course, you always use a range. The wider you make it, the more likely it is to get within it.

I am going to pass on a little story that Paul McCracken told us about before we finish. But this was your projection of the unemployment rate, and this is where we are. So unemployment has been a more serious problem than the Open Market Committee projected it would be.

Now, if you ask the question, why is this recovery so different, why aren't we coming out of this recovery, and you try to search for explanations, it is a complicated problem. I am prepared to concede that. And there are important structural changes that are taking place.

But I can't help but think it has some relationship to monetary policy, and I am going to show you a couple of charts, and I am going to throw some quotes at you from some very distinguished economists.

This is the Fed's target range for M2 growth. In 1991, you were barely within the range. We have done it for 1991 and 1992. And in 1992, of course, you are below the 2.5 percent. (See chart below).

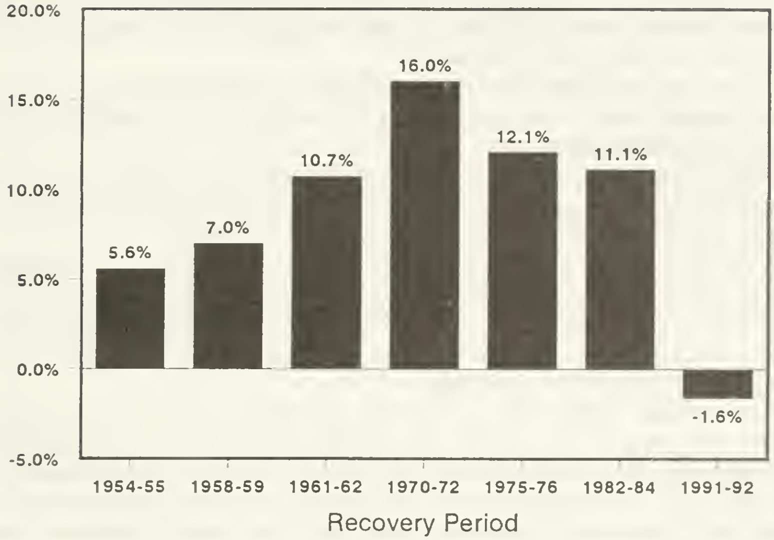


Now, you are talking about lowering it to 2 percent, which I guess would get you within the range. That is one way of doing it, of course. You don't make the target, you just lower the range.

Now, remember the previous chart about the difference in recovery in this recession. Now, this shows, if you start searching, an absolutely marked contrast with the growth of real M2 in this recovery compared with previous recoveries in the postwar period. In fact, we have got a minus figure in this recovery. Previous recoveries, anywhere from 6 to 16 percent. (See chart below).

Growth of Real M2

During First 20 Months of Recovery



Source: U.S. Department of Commerce, Joint Economic Committee

I know the Fed is now pushing the technical explanation—I do not want to put the whole argument on the money supply, and we can argue about that—but in the testimony before our Committee on December 30, we had Paul Samuelson, who came in with a very strong statement. He and Jim Tobin have both been sharply critical of the Fed's monetary policy and essentially asserted it is too little and too late. Both Nobel Prize winners. You may say they come from a certain point of view.

Martin Feldstein wrote in a *Wall Street Journal*:

> The monetary growth targets should be raised by a third to assure a viable recovery.

Milton Friedman, in October of this past year, in a *Wall Street Journal* article entitled "Too tight for a strong recovery," said, and I quote:

> The Fed's inflation objective is close to being achieved. Indeed, the Fed has temporarily overshot continuation of M2 growth at 2 percent per year would imply actual deflation, not negligible inflation. Given its departure from its own policy, the Fed now needs to speed up sharply monetary growth to bring M2 back to its target range and then hold it there.

Paul McCracken said:

> The basic drag on the economy, however, more than anything else, accounting for the unusually anemic expansion of output and employment

> since early last year, is an insufficiently expansive basic monetary policy in 1991 and 1992.

Now, that is a broad range of very eminent economists. In fact, it covers the spectrum, frankly, of people who are in agreement in criticizing the Fed's monetary policy. We have had a dialogue over the last couple of years in terms of whether the Fed has been behind or ahead of the curve, and I think you have been very much behind it.

A year ago last Christmas, you gave us a Christmas present when you made a sharp drop in the rates, when you finally began to catch up with Fed policy in previous recessions.

Now, I am deeply concerned about the Federal Open Market Committee minutes in the last meeting indicating that you are thinking of tightening up. That would just cut this possible recovery off at the knees.

You come in and urge the Congress not to do an expansive fiscal policy. But if you have a restrictive or contractionary monetary policy, you don't provide the offset we need in the monetary area in order to have the kind of fiscal policy that you want. You are going to, in effect, provoke, perhaps, the very thing you assert that you don't want.

Now, I know we are trying to explain away this M2 thing. I am prepared to look at the case, but I have some doubts about it, and I am reminded of the statement that Paul McCracken made when he appeared at our hearing on December 30. He talked about the proposal to lower the target rates. This is what McCracken said. This is not me talking. I am quoting President Nixon's chairman of the Council of Economic Advisers and a member of the council under President Eisenhower.

> Federal Reserve policy reminds me of that old story of the man who stopped for gasoline at a station and noticed the target on a building with a bullet right through the bull's eye. And he said, My word, who is the marksman who can hit it that way? And the station attendant said, He is the village simpleton and he is standing right there; ask him how he does it. And so he was asked and he said, Why, it is very simple. I shoot the gun and then I draw the target right around it.

Now, I have a suspicion that this is what the Fed is in the process of doing when it talks about lowering its rates.

In your response to Chairman Sasser of the Senate Budget Committee, you said:

> I will be circulating your letter to the other FOMC members so they will be fully aware of your views when they consider the ranges at their next meeting.

Chairman Sasser expressed many of the same concerns I am expressing here this morning.

So the first question that I want to put to you is a very procedural one, and I want to defer to you so you can respond to the presentation that I made. The Fed got in touch with us immediately after this Committee's hearing on Wednesday, December 30, with Paul Samuelson and Paul McCracken, and with Lee Hoskins, a member of the Federal Open Market Committee.

I have to be careful because I recall at one point that you had to fly to Chicago in a late-night meeting in order to get a dynamic going that would enable the board to ease monetary policy at that time. Of course, that is a problem you have, in terms of the dynamics of the Open Market Committee itself. But to be fair, we brought in someone with a very different viewpoint. That is all contained in the transcript of the hearing.

So the first question I would put to you is whether this hearing transcript has been circulated to the other members of the FOMC, and if it hasn't been, can it be?

Mr. Greenspan. I believe it has. Yes, I have seen a distribution list on it, and it has been.

Senator Sarbanes. My second question is, at the unemployment hearing on Friday, January 8, with the Bureau of Labor Statistics, we developed at some length both the difficult unemployment situation, which continues to exist, and we also developed the very positive record on the inflation front, and pressed the point that by any objective standard the problem facing the economy now is economic growth and jobs, and not an inflation threat. We always are concerned about inflation, but I don't think in the current context it can be given a primacy.

And I would also ask you that the transcript of that hearing be distributed to the members of the Open Market Committee, if it has not yet been done.

Mr. Greenspan. That is January 8?

Senator Sarbanes. That is the latest hearing with the Bureau of Labor Statistics on the unemployment figures and on the price level.

Mr. Greenspan. It was on the day of the release of the unemployment report?

Senator Sarbanes. That is right, Friday, January 8.

Mr. Greenspan. We shall see that that gets done.

Senator Sarbanes. I appreciate that very much.

Now, what about this problem? Can we get from the Fed a sufficiently accommodating monetary policy in order to get some economic growth and job restoration going? How serious are those minutes of the November meeting, which suggest that the Fed in this context is going to start to tighten monetary policy?

Mr. Greenspan. I disagree with your interpretation of what those minutes state.

Senator Sarbanes. Well, that is a good start. I am pleased to hear it.

Mr. Greenspan. Indeed, I indicated to Senator Sasser in my response to him, the issue that we were confronting in those discussions and which was reported in those meetings was a problem of deciding what one does if it is our conclusion that the particular construction of M2 in this environment, with this very sharply sloped yield curve, with a number of other aspects of the financial system suggesting that M2, which has served us so well as a proxy for the financial system, has veered off in a manner which is no longer, at least at this particular time, an appropriate proxy for what the financial system is in fact doing.

Therefore, the question is obviously, one, do we redefine M2? I would suggest that that is not a desirable thing to do, because I hope at some point, as it has in years past, it will reassert itself in a more stable manner. Two, do we recognize that there is a temporary problem with M2, and one which has created a very dramatic change in the relationship between nominal gross domestic product on the one hand and M2 on the other, and make our adjustment of the ranges to accommodate that view?

Let me just say, in the context of the chart which you showed about our forecast of the unemployment rate, the actual nominal gross domestic product that we were forecasting in that context came out reasonably well. Indeed, I would say that the real gross domestic product that has emerged in 1992 is probably in excess of what we would have expected.

So what we were observing in the November meeting was a phenomenon in which economic growth, the level of real activity, was moving along at a reasonable pace, but the M2 that we expected to be associated with it, at a level which would be parallel, indeed declined very significantly for technical reasons. So that was the context of that conversation that we were having at the FOMC, and indeed what we reported in the minutes was a reflection of how to handle this technical problem.

Senator Sarbanes. I am not sure it is a technical problem. I am not prepared to concede that. If you came in here this morning and said, we perceive a growth in money supply and an expansion in the economy, and a recovery of jobs, and an acceleration of the inflation problem, that belies where the money supply has been, and therefore we think there is something wrong in our calculation of the money supply because we are not even at the bottom of our range, and yet we are getting tremendous economic growth, we are getting tremendous job restoration, we are beginning to get an accelerating inflation problem. There is something amiss here, and we have begun to analyze this thing and have concluded that there is a big technical problem, and that somehow the monetary policy is working to provide a stimulus as reflected in these various factors that I have talked about, and therefore we are going to have to rethink how the money supply works—that is not what is happening.

You are out of your range. You are below your range. These other economists are sharply critical of it. The economic growth is far less than in previous recoveries. The job restoration is in marked contrast. There is no inflation problem. In fact, the performance there is the best it has been in 25 years. You are out of your target range, and you are saying, "Well, we have to redefine"—you are going to redraw the bull's eye, just like in that story I told. Is not, maybe, the problem your failure, in effect, to get a monetary policy that will accommodate the possibilities of economic expansion?

Mr. Greenspan. Senator, you are not going to get me to criticize a group of old friends of mine. I happen, in this particular case, to disagree with them.

Senator Sarbanes. Well, they have been criticizing you, so it is fair game. Go ahead, please.

Mr. Greenspan. I don't think they are criticizing me. I think they are criticizing the system; they are criticizing policy, which is surely their appropriate role. I could array for you a whole series of people who think we got it wrong in the other direction. It is a very difficult issue, which we are all endeavoring to make a judgment on.

I will tell you this, if you take the implied economic models which are involved with those who basically are saying that the growth in money supply is going to create some significant problems or has created significant problems in the economy, those models cannot explain the levels of economic activity that have emerged in the second half of 1992.

SENATOR SARBANES. My time is up, and I don't want to abuse my colleagues, but I am not relating, at all, to the money supply.

MR. GREENSPAN. The action is on the interest-rate front.

SENATOR SARBANES. The fact of the matter is, we have a recovery that is not restoring jobs, that is not responding. We have to get this economy moving. If the Fed doesn't respond, it is going to increase the pressure on the Congress to respond on the fiscal front, which is constantly what you assert you don't want to see happening, and you may, in fact, precipitate the very course of action you warn against by not having an adequately accommodating policy.

We want that message to go very clearly to the members of the Federal Open Market Committee. In fact, I am beginning to think we ought to bring all the members of the Federal Open Market Committee in here for some of these hearings. A good number of them never appear before the Congress because they are selected by private interests and not nominated by the President, not confirmed by the Senate, unlike you, who has to go through that process.

But I am going to defer now. I appreciate the commitment to get to all the members of the Federal Open Market Committee the transcript of both of these hearings—the December 30 hearing on monetary policy for 1993, and the January 8 hearing on the latest unemployment and price figures.

Senator Bennett, please proceed.

SENATOR BENNETT. Thank you very much.

This won't be nearly as stormy. It is my understanding that we went into this recession with the lowest level of inventory buildup that we have ever seen in a postwar recession. Is that a correct statement?

MR. GREENSPAN. Well, I do think we have seen a fairly dramatic decline in the ratio of inventories to sales as the efficiency of the system has so improved that the abnormal inventory accumulations that so plagued us in the past clearly are not evident in this period.

SENATOR BENNETT. It would occur to me, then, that the fact that we went into this recession without that kind of inventory buildup to begin with, which, if we were to put it on a chart it would be "normal," means that as we come out of the recession, we don't have the inventory buildup engine to cause people to be hired back, brought back to work at General Motors, or wherever, and that those jobs are gone, and they are gone forever. Just because we have eaten through inventory doesn't mean that we bring the workers back to General Motors to build more Chevrolets and Pontiacs.

The efficiencies of the system are causing parts of Chevrolets and Pontiacs to be built in Canada or Singapore or Mexico or wherever, and those jobs are gone and they are not coming back just because of something the Fed may or may not do. It is a structural thing, which I think you referred to when you said the models have broken down and the types of structures are very different from the past. Is that a fair opinion on my part?

MR. GREENSPAN. I would say that the Federal Reserve policy obviously does have an impact in conjunction with policies of the Federal Government's fiscal operations to effect levels of economic activity, and thus indirectly to affect different industries. But it is certainly the case that actions taken by the Federal Reserve cannot directly impact on what the operations of a particular plant or particular industry will be.

SENATOR BENNETT. So, as we move more and more into a global economy, as we move into an economy more dominated by service industries than manufacturing industries, we get to the point where the old models don't work because the economy has changed. It is not broken in the old sense; it is changed in a very new sense, and we need to recognize that.

I think I hear from what you are saying that you do recognize some of those forces that are working in the direction in order to give us models that can more accurately predict the future than the old models would have been able to do?

MR. GREENSPAN. That is correct, Senator.

SENATOR BENNETT. That is very encouraging to me, because I see no point in wishing for the old days. Bad as they may have been, they had some predictability to them. We have to recognize that in the changed economy, that predictability is going to go, and we are all going to look bad if we try to use old models to predict new patterns.

Let's talk about the role of technology and productivity for a minute, because from the days of the Luddites, technology, whether it is spinning wheels or PCs, have always threatened existing jobs, at least in some people's minds who don't recognize that ultimately they create far more jobs than they destroy.

Some of the crystal ball gazers are saying, we are going to see a revolution from fiber optics and satellites and things of that kind, will be as great as the revolution of the invention of the PC. Do you see anything like that on the horizon, or is that beyond the purview of an economist, and we are both here speculating?

MR. GREENSPAN. No, I think it had better be in the purview of economists, or we are going to miss the boat, so to speak.

As I have testified before this Committee in the past, and certainly before other committees of the Congress, over the years we have been watching the structure of the gross domestic product as it moves from what it was, say, at the turn of the past century—a heavy industrial-based type of activity, where the physical bulk of the GDP was a crucial issue—to one in which the proportion of the gross domestic product, which are ideas as distinct from physical volume, has become an increasing part of the real economic value added. And that is an irreversible process. In other words, we do not lose knowledge, and technology continuously advances. And what occurs as a consequence is that the specific gravity of the GDP goes down relative to real value.

That is the reason why, incidentally, we have such an increase in trade across borders. That is, goods are lighter, which means they are easier to move, and therefore easier to move across borders, and that is why the global economy has become a realistic concept.

That process will continue, and we will see that an ever increasing proportion of what it is that we create is of an impalpable nature, and whether or not it is a big shift from heavy copper wire to lighter fiber optics, or whether we are shifting from the old vacuum tube to the microprocessor or something related to communications, that is an irreversible, continuing type of activity. And I would suspect that if we could reproduce the American economy of, say, 2020, we would find it really quite different from where it is today.

Senator Bennett. I find it significant that the richest man in the United States right now is Bill Gates, who owns no huge factories or ranches, no tremendous commercial enterprises that we would think of 50 or 60 years ago. It all comes out of his head. And the intellectual product has made him the richest man in the United States, not the physical product of a steel mill or of an automobile factory. And I think that is a demonstration of the kind of structural differences that we have.

One last question. I have heard some economists say that what we have really had in the 1980s is a speculative binge similar to tulip mania among the Dutch a few centuries ago, whether it has been the Wall Street activity or real estate activity and things of that kind, and we are coming out of the lift of that speculative binge.

We have seen the Japanese real estate prices and stock market prices lose something like two thirds of their paper value, which would lend credit to the idea that we have had such a speculative binge. One of the things that fueled it was the fact that the effective cost of capital in Japan was zero because of the way the thing was structured, and you understand that better than I.

Is there any chance, if we were to push interest rates in the United States still further down, that we would get to the point where the real cost of capital might be zero in America, and fuel anything of that kind on our part?

Mr. Greenspan. Well, there is a dilemma here in precisely whether we are defining the cost of capital in a short-term or long-term sense. It is in fact the goal, or should be the goal, of economic policy, or at least one aspect of it, to create the lowest real rate of long-term capital cost.

In short, what we ought to try to do is to remove the risk from the cost of capital and essentially get the lowest real equity cost of capital that we can get, because what that will do is enhance the growth in capital investment and increase standards of living.

That is the general goal and is the reason why I raise the issue of a noninflationary environment being a precondition for maximum sustainable economic growth; that is, basically the lower the real cost of capital, other things equal, the greater will be the growth rate.

But there are occasions when we try in the financial system to drive the cost of capital down either by a big bulge in stock prices or by sharp declines in interest rates which cannot be sustained in the longer run, and that is not the same thing as reducing the long-term real cost of capital. That is a forced type of activity which in fact has too often in the past, both in the United States and elsewhere, created a stop/go type of environment.

The example to which you alluded to—the Japanese bubble in the mid- to late 1980s—has to be differentiated from setting the broader question of the desirability of getting the real long-term interest rate at its lowest sustainable level and the real cost of equity capital also at that level.

And policy that is directed to accomplish that would achieve as much as I can imagine to create long-term sustainable growth, in the context of the technological advances, which are so crucial to economic growth.

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Senator Bennett. Thank you very much. My time is up.

Representative Obey. Senator Bingaman, please proceed.

Senator Bingaman. Thank you very much, Mr. Chairman.

Mr. Greenspan, would you just clarify for me two factors that, I think, need explaining. One is that we have a lower growth rate as we are going through this recovery. We have a lower rate of increase in our growth than we have had in previous recoveries. And that relates to what our fiscal and monetary policies ought to be.

A second and somewhat distinct issue, I believe, is that even for the rate of growth we have, we have too little job creation. And I guess I would like you to address that second point.

Is this new animal that you referred to—this new economy—as part of that, we could actually have what we would think was, by historical recollection, a reasonable rate of growth and still not have job creation at a level that we need? Is that the situation we are in, and if so, why?

Mr. Greenspan. Senator, you have to differentiate between short-term and long-term patterns. What we have been observing in the last year and a half is a very dramatic increase in productivity, well in excess of what we would have expected with this type of tepid economic growth that has occurred.

If that continues, that is saying two things. One, we have underestimated the potential long-term economic growth of the economy; that is, in fact, it can grow faster than most economists have recently been forecasting. In short, if you assume that, as a lot of economists do, say, productivity growth over the long term is expected to be only 1 percent a year and it turns out to be significantly more than that, then clearly the potential growth rate of the economy is quite significantly higher. But there is no reason in that environment why employment growth cannot also rise.

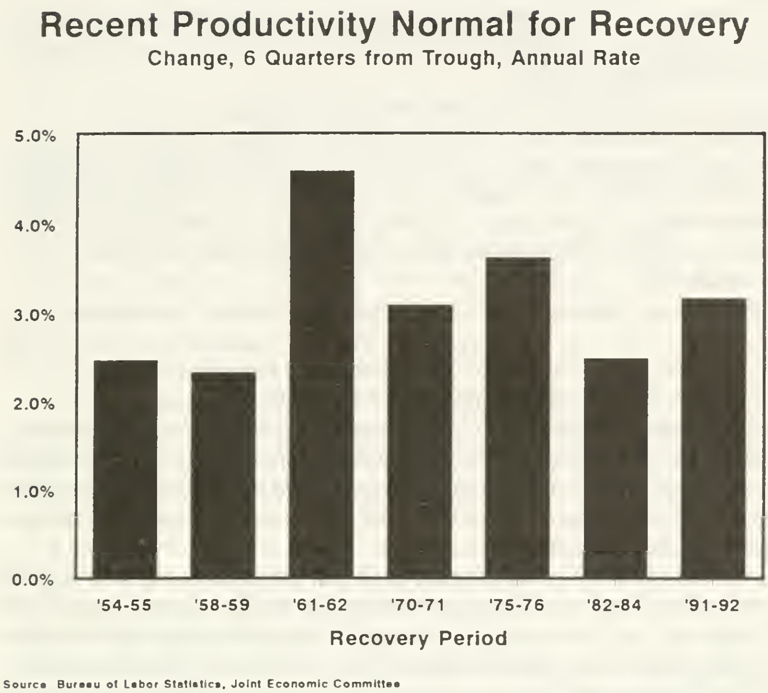
What it will mean, essentially, is that both real growth and employment rise, but in this particular period it is important to recognize that this is a very unusual phenomenon, and we are not quite sure yet whether to take this presumed cusp in productivity as being other than just a short-term phenomenon.

If it is a short-term phenomenon, and the growth rate continues where it has currently been in the last half year, then obviously productivity will slow down and arithmetically that means that employment growth must accelerate, and in fact accelerate quite significantly.

We don't know yet exactly how that is going to emerge, but I should say to you that in either case, employment growth, if this economy is continuing to grow, will doubtless pick up from its extraordinarily slow pace of the last several years.

Representative Obey. Senator, will you yield on that point for a second?

I just want to use this chart to demonstrate that I am somewhat dubious about the suggestion that productivity increases are really important in this respect, at least as important as you indicate. Certainly we are experiencing an increase in productivity, but as this chart demonstrates, coming out of previous recessions, productivity normally increases, and in fact if you take a look at the rate for the 1991-92 so-called recovery period, that certainly is not higher than it has been in previous comparable recovery periods. (See chart below).



MR. GREENSPAN. If you adjust for the fact that the recovery has been very slow, it is clearly well in excess of what one would expect. The major determination——

REPRESENTATIVE OBEY. Why would companies want to lay off people so they get more out of each worker without trying to get more out of the work force? Why should we be surprised about that?

MR. GREENSPAN. If one looks at those earlier periods, what you will find is that overall economic growth was very significant during that period, and that productivity growth was only a modest part of the total growth. Indeed, one way of looking at the increase in employment in the earlier periods was basically that.

What is different about this particular period is that all of the economic growth is a consequence of productivity increases, and when you try to determine what productivity is going to do, the levels of economic activity are a very crucial determinant of that. And when the economy is growing very rapidly and fixed costs fall per unit of output, productivity naturally rises very extraordinarily.

What is different about this period is that you have, if you look at your chart, strong productivity growth, despite the fact that the growth in overall output has been extraordinarily modest. And that is the issue which I think is crucial here.

Representative Obey. I don't want to interrupt further. I am sorry.

Mr. Greenspan. Let me make one final point. If productivity had followed its normal relationship to output in this recovery, employment growth would have been significantly higher.

Representative Obey. I will get back to that point later.

Senator Bingaman. Let me ask about one other issue. Could you say anything or tell us anything about how the very large and chronic trade deficit that we have today and have had throughout most of the 1980s, how that has changed our ability to pull out of this recession, and in particular how it has affected our ability to begin creating jobs at a reasonable level as this recovery has taken off?

Mr. Greenspan. Senator, I don't think it has had much of an effect, because remember that it was only a few years ago that the unemployment rate was in the low 5 percent range. At that time we had a very large trade deficit. So it is difficult to draw the connection between the two in that context.

There is no reason that I am aware of why that would be a particular drag on our economy if foreign investors are willing to finance the current deficit. Obviously, if that were not the case, if foreigners did not wish to buy our government and private securities, then it would affect our recovery, but there is no evidence of that even remotely.

Senator Bingaman. My impression was that throughout the last half of 1992, we kept hearing that the recovery was being led by exports, and I guess that it strikes me that, for some of the reasons you state in your prepared statement, export growth has stalled, and it does not look as though that export growth is going to provide a major impetus to an additional strengthening of the recovery in the future.

Mr. Greenspan. I think that is right, Senator. Our exports were doing exceptionally well, and we were increasing market share in the world largely because our productivity was better than one would have expected, and the efficiency and our international competitiveness have very clearly been improving.

But, remember, the overall outlook for the rest of the world for our trading partners has deteriorated quite significantly. Indeed, at this stage the United States stands out as being the one major industrial nation whose economy is doing reasonably well.

But another way of looking at that is, our foreign markets are doing less well, and one must assume that we just can't continue to increase our market share indefinitely. And I would suspect, as indeed all forecasters do, that the weakness among our trading partners will feed back into a less viable foreign sector for the American economy.

Senator Bingaman. So we will see a larger trade deficit in the next year than we did in the last?

Mr. Greenspan. If the American economy continues to improve, and the rest of the world remains weak, then one could expect that our imports would rise relative to our exports. That would be the normal expectation that one would assume if the United States were doing better than our trading partners.

Senator Bingaman. [Presiding.] Senator Craig, please begin your opening statement.

OPENING STATEMENT OF SENATOR CRAIG

Senator Craig. Thank you very much, Mr. Chairman.

Chairman Greenspan, welcome to the Committee. I apologize for not getting here earlier.

I am pleased you had breakfast with Secretary Bentsen this morning. I hope this is an omen of better things to come.

I say that in the context that I noticed in your background that you were once a saxophone player.

Mr. Greenspan. I have tried to hide that, but not successfully.

Senator Craig. In the Henry Jerome orchestra. Can I suspect that maybe you are going to be allowed to be first chair of the new sax section downtown?

Mr. Greenspan. May I offer no comment?

Senator Craig. Having said that, I also noted this morning, this Committee was awfully quiet about a certain kind of deficit that is generated here on Capitol Hill in large amounts, so I would like to direct at least a portion of my questions, as it relates to your role in that deficit.

Our Administration has, for a time, at least, talked about short-term economic stimulus versus the need to begin any immediate long-term deficit reduction program. I know they have changed a bit as new figures have come out. Do you buy the argument that deficit reduction undertaken too fast or too soon could actually hurt the economy at this time?

Mr. Greenspan. Senator, I find that noncredible, if I may say, if for no other reason than it is very difficult for me to perceive passage by the Congress of a sufficiently restrictive budget to create the degree of so-called fiscal drag, which would be overwhelming. I would almost say that I would like to believe that were possible.

Our problem is really on the other side, on the difficulties in reducing this deficit. But the necessity of doing that, because of the long-term rise in the deficit which CBO indicated to the Congress yesterday, or the day before, suggests to me that the problem of getting the deficit down is going to be extremely difficult, and if we keep in the back of our minds that we should be very careful not to overdo it, we are going to find that we will make the job more difficult.

There is no question that theoretically one can create a cut in the deficit which is, in a sense, overdone. That is, it creates fiscal drag and will have a negative impact on the economy. I find that highly theoretical in today's context, and I would hope that that fear not restrain the hand of the Congress in adjusting the long-term deficit to where the real problem lies.

Senator Craig. In that context, to what extent do you consider a major deficit reduction package, in part, a prerequisite to a monetary stimulation? Everybody wants to talk about stimulating, yet nobody wants to talk about deficit reduction. It seems like there has to be some hand-in-glove here.

Mr. Greenspan. Obviously, if there is a significant package which the markets perceive as credible, and as a consequence long-term interest rates begin to move down, as indeed they did on Monday in expectations of such an event, then clearly the financial system itself begins to ease, as long as policy adjusts to that. But it is a much more complex set of relationships than just saying the budget deficit has been reduced, and therefore certain things happen in monetary policy. In formulating policy, it is clearly an important aspect of what it is that we respond to and what we react to. But to assume that, as a number of people do, there is a simple relationship, or simple tradeoff, really is a view of the way the system worked, perhaps, 30 years ago when economists used to believe that there was a very simple tradeoff between fiscal and monetary policy without considering the fact that what we have learned in recent years is how important inflation expectations embodied in long-term interest rates are to economic growth.

In that respect, I would say that there is not a bilateral relationship, it is trilateral, in the sense that we all have to observe what the total process is and try to find the most appropriate set of policies which lead to sustainable growth.

Senator Craig. With government borrowing, right now, consuming all private-sector savings and retained corporate earnings, or the equivalent thereof, aren't we really setting into place a very difficult set of circumstances that would tend to create very flat, long periods of low growth without the kind of capital necessary to invest in the marketplace to get it moving?

Mr. Greenspan. Senator, the absorption of the private saving by the Government has not yet taken it all, but it has absorbed a very substantial part, and indeed, to the extent that is the case, we either have to borrow the funds from abroad, or have equity investments from abroad to finance our capital investment.

And it is a combination of the amount of available saving and investment, coupled with the productivity of capital—that is, the degree of technology's capability of improving things in the context of what I was discussing with Senator Bennett—that will determine how capital affects the rise in living standards. But very obviously, if we have no private saving and we cannot borrow it from abroad, unless we have such extraordinary technological capabilities that we can create massive productive assets with very little investment, then clearly it would crimp the growth in standards of living very measurably, and it is in that context in which I find the accelerated budget deficit, which we are proceeding in toward the turn of the century, of very considerable concern.

Senator Craig. One last question, Mr. Chairman. Congress and the new Administration will soon embark on some kind of new budget agreement. And let me ask this, in the context of what that agreement may or may not be, how might markets respond, as you mentioned earlier.

If we do what we did in 1990 again, and by that I mean raise taxes substantially and walk totally away from our spending reduction targets, as clearly I think we did and as I think the general economy now reacts to, how can we get the markets to believe that we are sincere, that we really will follow suit when we have had well over a decade of saying one thing and doing almost another by two and a half times?

Mr. Greenspan. Senator, what the markets would probably respond favorably to—and I hesitate to talk for such an abstraction as the markets—are actions, with respect to the federal budget, which are specific legislative initiatives per lines in the budget, not goals or caps, not various different rules by which certain parts of the budget will run, but very specific hard-wired actions which affect the levels of expenditures and revenues in, say, five, six, eight years from today.

Now, there is no question that the Congress could obviously reverse those actions at a later date, and I don't deny it and I suspect market participants wouldn't deny it. But most of it probably would not be reversed. And were that the case, were we to, for example, recognize that we cannot accept this accelerated growth in the budget deficit and put in legislative changes which address those numbers in 1996, 1997, 1998, those types of actions would be perceived as at least more credible than what we have seen to date.

Whether or not there is such a deep-seated degree of cynicism out there that nobody believes anything, I am not sure, but my impression is that that has not occurred. In other words, the evidence that President Clinton and his associates are very seriously focused on—this long-term budget deficit—has impacted in the marketplace, as we have seen in recent days.

And that would suggest to me that they are not cynical, that they really are looking for real reasons to believe that the deficit will be brought down. And should that be the case—as I have said many times before this and other committees—long-term interest rates would fall, and that would create far more short-term stimulus than most anything else we could contemplate.

Senator Craig. Well, thank you very much, Mr. Chairman. I hope the new sax section recognizes your talents.

Thank you.

[The written opening statement of Senator Craig is on p. 58 of the Submissions:]

Representative Obey. [Presiding.] Mr. Andrews, please proceed.

OPENING STATEMENT OF REPRESENTATIVE ANDREWS

Representative Andrews. Thank you, Mr. Chairman.

Good morning, Chairman Greenspan. It is nice to see you again. I would like to ask you, just if you would, to follow your line of thinking in response to the Senator's questions, and ask you to focus for a moment on tax policy.

Earlier this week Secretary Bentsen suggested some kind of energy tax. A few days ago, the new Secretary of Labor suggested a $15 billion jobs program. I wonder if you would give us your thoughts as we go about dealing with the budget deficit, whether or not you think additional revenues will be needed, and if so, what kind of caution would you suggest to the Senate Finance and the House Ways and Means Committee in going about that process?

Mr. Greenspan. I would hesitate at this stage to get involved in the issue of specific elements of whatever budget package the President is constructing. He has a difficult time as it is to find the appropriate balance that will create the type of improvements that he is looking for. And I don't think I can add terribly much to that particular process.

The only thing I would suggest is that we have to recognize that one of the major long-term problems at this stage is that the current services budget increase in outlays in the out years, as the defense decline phases out and as the savings and loan costs come down, now presumably increases at a rate faster than the current services tax base.

And what that means is that unless you bring expenditures down, you have to increase taxes every year. And obviously there is a limit to what one can achieve in that regard, because there clearly are suppressing forces every time we raise taxes.

So it is crucially important that we recognize that the elements involved in bringing the budget deficit down in the longer term have to be on the expenditure side, because they cannot be on the tax side because that it won't work. It is an arithmetical economic problem.

Having said that, that is about as much as I can offer, and how one achieves the appropriate balance really gets to the problem of how one gets what into a budget in which every line has a constituency who wants it there.

Representative Andrews. Well, one of the things you suggested to the Ways and Means Committee last year was that we needed to be playing a long ball here, encouraging long-term savings. I assume you still feel that way, and would suggest that the Congress move in that direction if, in fact, there is some kind of revenue bill.

If there was a revenue bill, and there certainly appears that there will likely be one this year, do you think it is important that there be incentives built into that bill—investment tax credit, for example?

Mr. Greenspan. I don't want to get specifically into any of the individual revenue areas. As you know, I have testified before Ways and Means on the desirability of indexing the capital gains tax, both retrospectively as well as forward, because I do think that in the context of the difficulties that small businesses are having and the employment problems that are so obvious, when one looks at these charts, that is another way of saying that small business employment is subnormal. Anything we can do to encourage incentives which will create new businesses and new ideas, especially in the context of my colloquy with Senator Bennett is important. We need to encourage enterprise, and in the context of the tax code, it strikes me that is the thing that is missing most at this point.

Representative Andrews. Thank you.

Thank you, Mr. Chairman.

Representative Obey. Senator Dorgan, please proceed.

OPENING STATEMENT OF SENATOR DORGAN

Senator Dorgan. Mr. Chairman, thank you very much. And let me indicate how pleased I am to be with you on this Committee and serve with you again, working on economic issues.

Chairman Greenspan, welcome. I would like to ask you a couple of questions about measurements.

You are an economist and you undoubtedly are flanked by economists behind you, and you work with economists all day and all week and all month and all year, and when you speak to us and to the country, you speak based on your evaluation of measurements. Some of your economists could almost do it from a bunker, I expect. You take a look at the sheets, see what the numbers show, see where the numbers move, and give us an analysis of what that means for our people and for the country.

I have been wondering for some time whether these measurements really work at all and whether they are really very useful. I wonder if what you measure might not be the equivalent of trying to fly a stealth bomber with the dials and gauges of a gas stove. If you see that, right out this window, there is a car accident, you say that accident is going to represent economic growth because there is going to be repair, a lawyer litigating, a hospital bill.

The reason I am asking you these questions is, I sat on the Ways and Means Committee throughout the 1980s in which we had seven years of broad national economic growth reports, and now we look back at the 1980s and see that what was economic growth represented a sickness that, in my judgment, has caused serious problems for this country in the late 1980s and the 1990s.

For example, we end up as taxpayers owning junk bonds in the Taj Mahal. An interesting sort of hood ornament for the failure of the 1980s, all of the speculation, all the debt financed transactions, most of which created no new wealth, most of it represented by numbers which said, "This is good, this is growth, this is movement."

I am asking you if, now having had this experience of hostile takeovers and junk bonds and an incredible orgy of greed, including things I have asked you about, highly leveraged transactions, whether we ought not now take a look at whether these measurements represent what is real to people in small towns across the country about whether or not we are progressing and moving ahead and growing.

Mr. Greenspan. Well, Senator, I would like to indicate that, perhaps to your surprise, we economists do think about that issue, and try to differentiate the types of growth or types of economic output which really directly benefit people, those of which are insurance, such as defense expenditures; those of which are repair or health expenditures. You even get the problem where the difference between the climates is relevant, because those areas of the country which don't have major fluctuations in temperature neither consume fuel nor air conditioning in very great amounts, and obviously that is not produced. If you produce it, it looks as though it is real GDP, but it doesn't help anybody in those regions.

It is a very tricky and very interesting question you raise, because we do think about that, and it is very important to recognize, from a so-called welfare point of view, what elements of economic output and how they are distributed actually create rising standards of living directly, and those which are peripheral to that phenomenon.

Senator Dorgan. But during the 1980s, I was in several hearings where I had the opportunity to question you. I was never able to determine whether you made any qualitative judgments about the difference in activities of someone who was creating a junk bond in order to allow a takeover minnow to go after an economic whale someplace, that created no advance and no economic activity and nothing but ruined jobs and dashed hopes, versus the borrowing of some money to buy a truck to haul some grain.

I was never able to determine if there was any qualitative evaluation by economists, or by the Fed, that one was better for the country than the other. Am I wrong about that?

Mr. Greenspan. Partially. You have to distinguish between how we as individuals and citizens make those value judgments and how we in effect do our jobs. The particular issues that you are raising are largely questions of regulation and tax incentives which are crucial to how government affects the structure and activity. And that clearly is congressional initiatives as distinct from monetary policy.

We have to, of necessity, take that structure as given and try to function with the value system implicit in it that is given to us by the Congress.

Senator Dorgan. And I accept and understand that. One of the reasons I was asking this question is because we have been looking at this issue of foreign corporations doing business in this country and failing to pay taxes.

Let me give you an example of one evaluation of that. One case is a company in Singapore, doing business with a company in this country and transfer pricing the profits. One case lasts 10 years and fills 19 file boxes full of data and depositions and litigation papers, and so on.

All of that I will bet is counted in our national accounts as growth. I would bet on it. Don't you think it is? It is lawyers, accountants, airplane trips, all of this, 10 years' worth of nothing is represented in our accounts as an advancement. In fact, it is a sort of national sickness because we are not moving ahead to do what we need to do to create jobs and advance the standard of living for people who live in our towns. And that is why I am asking, I wonder if we are measuring the right thing.

Mr. Greenspan. Senator, I think we are measuring the right thing. It is important, however, to interpret it correctly. And, depending on what it is you are trying to make a judgment about, the data we collect would enable us to make the types of judgments or correct the data as you would like to do depending on what you include.

For example, this came up in one very interesting way very early on when economists were trying to decide what should be included in the Gross National Product. Should the output implicitly of housewives be included? And that was a very important debate, because it is very obvious that there is activity that creates wealth in that process.

If we are going to put the imputed value of homes in the GNP, why not the imputed value of the services of housewives?

This issue has gone on for generations now, trying to define what is the appropriate measure of the Gross National Product which best reflects the welfare of the society.

Senator Dorgan. And we won't solve that today, but again I point out, if you are not in public office in Washington and are instead raising chickens, and I am not in public office, I am raising corn, and you and I simply exchange chickens for corn and we both are fairly happy about that exchange, my guess is that the car accident outside this building has a bigger impact on the measure of economic health in this country than the chicken and corn you and I raised for each other's consumption, at least in the current method by which you measure national progress.

It is a point that I hope you and I can talk about, because the issue today is, what is going to happen to this country in the future, what kind of growth rate? And you talk about the measurements of money and targets and so on, could you just for the purposes of someone in my hometown this morning who might be listening or watching the Chairman of the Fed, could you synthesize your analysis just in terms of your broad judgments about what we might see in the next 18 months?

We are told by some that we have long-term anemic growth ahead of us. We are told by others, gee, things are going to be better than most of us expect. How would you summarize what our prospects are for the next 18 months, or the short-term immediate term?

MR. GREENSPAN. Senator, I have eschewed doing that so far today, and I am not going to do it largely because I am planning to go before both the Senate Banking and the House Banking Committees, delivering precisely those forecasts in a very few weeks, and I would just as soon not give you my impressions, even though I don't know what the governors and the presidents of the banks at this stage have put down on their reports that are in the process of being collected.

SENATOR DORGAN. Are you generally optimistic or depressed?

MR. GREENSPAN. I tried to capture my view in my prepared remarks. We are making progress, but as I tried to describe it, whereas a year or so ago, I looked at the problems we were confronting in trying to adjust the debts that we had as trying to make progress against the 50-mile-an-hour head wind, the head wind is less now, but it is not zero.

We are not yet out of the woods of the various types of problems that we have been confronted with in recent years. There is no question that we have made very substantial progress.

The American banking system, which a little more than two years ago was in rather dubious shape, has improved very substantially. The instability in the financial system elsewhere, which we were greatly concerned about, has very dramatically become subdued. And a number of the problems which we feared might happen didn't.

And that is, in a sense, a measure of things getting better, but I wish to be very clear that I don't think we are there yet. We still have a ways to go.

SENATOR DORGAN. Mr. Chairman, thank you for your indulgence. I would like to ask one additional question in closing, if I might.

One of the things I have been thinking about in this issue of growth, all of us are chasing these twin goals, stability prices and growth. In the 1980s, we had years of economic growth. At least that was what we would read in the newspapers.

In my state of North Dakota, we didn't fare quite so well. So even if we reach the target of national economic growth and we say, all right, we are clearly out of a recession, clearly on the mend, the growth is now not dubbed as moderate but probably robust, even at that point we may find ourselves in a place where some of us in Congress are representing regions of the country where there is not growth but recession.

In North Dakota, as an example, my home county lost 20 percent of its population at a time when the newspapers were talking about all this wonderful growth. We need to think regionally as well as nationally, to try to understand what is going to happen to the Northern Great Plains region, what can we do to respond to some of those needs, particularly in the area of credit and other areas.

And I would hope to have a dialogue with you in the months ahead about how we can take a look at both the combination of monetary and fiscal policies, to care not just about the national aggregate—aggregate growth is important for a lot of reasons—but what is happening in some regions of the country that have suffered, in some areas in the country that have suffered, an increasing gap in income between urban and rural areas.

You know, for a couple of decades we were moving in the right direction. In the 1980s, there is now an increasing gap between rural and urban areas, and of course the state I represent is largely rural.

So I hope we can be discussing that, because I think that is also a very important element of answering the question, is this country recovering, or is it just the West Coast, the East Coast, and the South?

Mr. Greenspan. I very much agree with that, Senator.

Senator Dorgan. I hope we can spend some time working with the Fed on that. I will raise those questions repeatedly in the Congress, as well.

Thank you very much.

Representative Obey. Dr. Greenspan, we are going to be running into time problems so I am not going to be able to stay here very long, but let me simply make a summary observation, and then shift gears and ask you a couple of questions on a very different subject before we wrap this up.

Can you recall any period in modern history when inflation rose and unemployment was at 7 percent or more?

Mr. Greenspan. I am sure that if we looked at other countries similar to ours——

Representative Obey. In this country, I am saying.

Mr. Greenspan. In this country, I don't recall a specific period. I would be very doubtful.

Representative Obey. I don't think you will find one.

Mr. Greenspan. But let me put it to you this way, Mr. Chairman. It is technically feasible as indeed a number other countries have exhibited to us.

Representative Obey. I understand, but I think any rational person is going to be assessing the degree of risk, and I think we would say that with unemployment at these levels, the risk of inflation becoming a significant problem is minuscule if existent.

Mr. Greenspan. If you are asking me, do I think the inflation rate is likely to accelerate any time soon, the answer to that is, as I will stipulate, probably not. But I do think that it is important to be very clear that the issue is not short-term inflation solely. It is also the very important expectations of inflation in not one or two years from now, but four or five, six, ten years out. And that concern on the part of the marketplace has elevated long-term interest rates to a point where they are significantly above where they have been in previous periods of very low inflation.

So I would suggest to you that while it is certainly the case that there is no evident short-term inflation concerns, the markets have created a structure of interest rates which indicates that that concern exists out there, and that is probably suppressing economic growth now.

REPRESENTATIVE OBEY. Well, let me say, I have concern that is a mirror image of that. I don't really want to see a major economic stimulus package right now. I am more concerned with seeing us begin, right now, making the right investments in both the private and public sectors to assure long-term growth.

But when you have public opinion which indicates that two thirds of the American public still believes we are either in a recession or a depression, if the policy of government is not seen to be sufficiently responsive to those realities, which, in my view, are much larger than the potential of significant inflation growth any time soon, then I think you are going to see the release of a tremendous amount of political pressure to, in fact, have the kind of rapidly expansionary stimulus package that I don't think you want.

I also don't believe that developments—and I don't think you do—in Japan or Germany—the other two crucial engines of world economic growth—I don't think that what is happening in those countries is indicating any significant help in expanding the economy worldwide.

And I think that the problem we have is that the slow growth with which we have been plagued, and the slow degree to which we have come out of this recession, in fact, also helps suppress wage growth, and that in turn creates more long-term problems for this country.

I frankly believe that the chance of inflation becoming a more important threat to the economic well-being of this country than weak economic growth for the foreseeable future is about as great as the New England Patriots' chance of winning the Super Bowl next year. It just ain't going to happen.

And I really believe it is essential that not only the President properly calibrate his response to this very troubling situation that we are in, but I also think it is terribly important that you neither follow nor be perceived to be following a policy which leaves insufficient room for economic growth. Because in the last analysis, in addition to the problem of growth, we are dealing with two deficits. We are dealing with a budget deficit; we are dealing with an investment deficit.

You can better summarize than I can the drag which is created in the economy because of insufficient private investment. I know that you are concerned about that.

But that is mirrored on the public side as well. You can't see the chart from there, but the fact is that if you take a look at the federal budget and the investment portion of the budget—and I am not talking about the bleeding heart consumption items, I am talking about hard-nosed investment, investment in kids by way of education, investment in infrastructure that makes communities more efficient places to function, about investment in science research, programs like that—as a percentage of our federal budget, that investment portion has dropped from 16.5 percent of the federal budget in 1980 to less than 9 percent today.

And it is important if we are going to achieve the kind of sustainable growth that you are talking about. It is important in my view that we make the right kind of private and public investments at the very same time we are dealing responsibly with the deficit. And if we don't attack all three problems and focus only on one, we are going to strike out a lot. And that is not going to help anybody.

I think your role is key. And despite all the assurances or concerns expressed here this morning, the proof will be in the actions of the Fed. So we will simply have to watch and review what happens.

I would like to switch to a different subject, if I can, for just a moment, because I wear a number of hats around this place, and one of them is as a member of the Appropriations Committee. This is an area in which there is a renewed interest in accountability. And I know the answers to these questions, but I think it would be useful simply for the benefit of the public record, once again, to have you state them.

How much did the Federal Reserve System spend in 1992 to conduct its operations? For the total system? Was it about $1.7 billion?

MR. GREENSPAN. That is the right order of magnitude, yes. The operating expenses are $1.4 billion.

REPRESENTATIVE OBEY. Would you describe for the record how you get $1.4 billion as opposed to $1.7 billion? I would appreciate that. But let me ask you a question.

MR. GREENSPAN. I am sorry. What I was giving you is the budget of the 12 Reserve Banks. Part of the difference, not all of it, is Board expenses, which were $129 million, and the cost of the currency of $295 million. Remember, a goodly part of the operating costs are met by receipts that we get from the private sector for the services that we engender. But I think that reconciles the $1.7 billion.

REPRESENTATIVE OBEY. Would you explain, again, for purposes of the public record, how you finance your operations? Where do you get your money?

MR. GREENSPAN. Basically the monies that we get are created for the System, as a whole, through the investment in securities by the Federal Reserve Banks, which engenders a significant amount of income, the vast proportion of which, of course, goes directly to the Treasury. The remainder constitutes our operating expense; or more exactly, we budget our operating expenses for the System, as a whole, and with the exclusion of the dividends that are being paid by statute, the remainder of those funds go as direct payments to the Treasury Department and appear in the budget item under the receipt segment.

REPRESENTATIVE OBEY. So the point that needs to be made clear here is the fact that you do not receive your money through an appropriation from the Congress?

MR. GREENSPAN. That is correct.

REPRESENTATIVE OBEY. And the Congress does not in fact pass on your budget, nor does the President.

MR. GREENSPAN. We do report to the Congress on our budget, and indeed we testify on it before a Subcommittee of the Banking Committee.

REPRESENTATIVE OBEY. But there is no action required by the Congress or the President in order for you to receive your operating expenses?

MR. GREENSPAN. We do not use appropriated funds.

REPRESENTATIVE OBEY. Why shouldn't the Federal Reserve have to receive its budget through the normal process, just like any other government agency?

Mr. Greenspan. This goes back a long way, and really relates to the issue of the nature of the degree of independence of the Central Bank in this country. And it was judged early on that it would be appropriate for us to function in the way in which we do but be accountable——

Representative Obey. When was that initial decision made?

Mr. Greenspan. The decision was made implicitly in the Federal Reserve Act of 1913, in the sense that the Federal Reserve Banks themselves began to engender income by making discounts and eventually purchasing securities, and the creation of the Federal Reserve Board being financed from part of that goes back to the earliest days of the institution.

Representative Obey. As you indicated and as several members of the Committee indicated this morning, things have changed considerably since then. I understand the argument that is made that you ought to be able to draw on your own funds without having them approved by taxpayers' representatives because you want to remain independent. But I would suggest that I think times really have changed.

I am not at all convinced that in this age of modern communications —much fuller accountability—that that argument would hold much water with the people with whom I represent or anybody else represents on this Committee. And I would submit that you have a whole lot more to do and a whole lot more effect on the welfare of my constituents than in fact I do.

I would trade powers with you any time. And it just seems to me that President Bush didn't exactly refuse to demonstrate his independence vis-a-vis the Congress. He did that on a regular basis, despite the fact that we reviewed his budget. We had competition between branches, but at least we had the forum if not the reality of accountability on budgeting.

And I am really not persuaded that the time has not come to establish that kind of accountability with respect to the Fed.

Mr. Greenspan. Well, Mr. Chairman, it is fairly clear that we at the Federal Reserve Board and the Reserve Bank presidents are acutely aware of our responsibility to keep our expenses down. And we go through a very rigorous procedure to make certain that we run a very efficient shop. And I think the record over the years has indicated that we have been quite successful.

We at the Board, for example, spend a considerable amount of time making certain that the Federal Reserve Bank budgets are kept in check and that we audit what they do and make certain that there are no inappropriate activities which are being created.

Representative Obey. I didn't mean to suggest they are not, in any way. I didn't mean to suggest that. I am just questioning whether or not this institutional arrangement, which may have served the country fine in an era when virtually every other institution of government was closed. I mean, the Appropriations Committee used to hold its public hearings in private. You couldn't get your staff in, let alone let a poor member of the public in. We have had to change our processes, and I am really wondering whether the time——

Mr. Greenspan. Let me tell you what function it serves, and it is the judgment of the Congress to determine whether that is what you want.

It is fairly apparent that were we to be involved with an appropriations process, then clearly the ability to affect monetary policy can be engendered through that process, because he who controls the particular budget and controls who does what can run the organization. The Congress can choose to run the Federal Reserve if we are subjected to very detailed scrutiny and authorizations in our budgets.

Now, that may not be the purpose of what you would do, but it is clearly what would occur. And this is a judgment which the Congress has made over the years in its constitutional authorities with respect to monetary policy, with which we fully concur.

And my judgment is that the difficulty of having a Central Bank with a monopoly over the issuance of the currency in a democratic society is a very difficult balancing act to initiate.

My own judgment is that we have a society and an economy in which individuals make their choices on a day-by-day basis to save and invest and consume, and they construct an economy which has essentially long-term assets associated with it.

We build buildings to last a long time. We build organizations that have a long-time frame. And it is very important that the Central Bank be an institution which supports the stability of the financial system over the longer term.

I think this is the reason Congress chose to give the governors 14-year terms, and why it is that you have chosen to create essentially a significant degree of independence in the institution which has served us exceptionally well, and I would be, as a citizen, most concerned if that were abridged.

And I am fearful that a significant retrenchment in the independence of the institution, which could occur for a number of reasons, would not serve the American people better in any material way that I am aware of.

Representative Obey. Let me make the point that you indicate that you deal with institutions that build assets. That is true, but I would suggest that the institutions are building assets for a small number of people. There are an awful lot of people in this country who have virtually no assets. And I think that they often feel that government is being managed on behalf of the folks who do to a much greater extent than it is for the folks who don't.

Mr. Greenspan. I wasn't referring to assets in the context of who owns what.

Representative Obey. I know you weren't, but I was using the word in a different way to drive home a different point.

Mr. Greenspan. I am referring to the issue of investment in the structure of our economy, which has created for the average American the highest standard of living that has ever existed. Those are the assets which do it, the tools that we have been able to create and build over the generations that have created our standard of living.

Representative Obey. But, for example, a decision on your part to come down on the side of protecting those who do have financial assets by being more concerned with the inflation rate rather than coming down more on the side of those who have very few assets, especially those who have faced economic hardship and face dwindling assets because of their being unemployed, I think that creates some very unhealthy populist—in the worst sense of that word—tendencies in this country.

Mr. Greenspan. I would agree with you if that, in fact, was what we were doing. Our basic view essentially is to support the total system, and it is not appropriate for a Central Bank to come down on one side or the other in this particular issue. I think that what——

Representative Obey. But your policy judgments do.

Mr. Greenspan. Policy judgments do, but the Central Bank should not, and we do not.

The issue is essentially the recognition on our part that the overall economy in which every individual in our society contributes and benefits requires a stable financial system. If we cannot provide that, then the economic system would be in serious difficulty. Our view is essentially that we are supportive of the economy and therefore the society as a whole, and it would be most inappropriate for us to craft our policies to try to focus on the benefits of any particular segment within that society.

Representative Obey. But, in fact, your policies do just that. Our policies do just that. We may not describe them that way, but in fact those policy decisions determine who will have more and who will have fewer assets in this country. We do it every day.

Mr. Greenspan. I agree that whatever we do obviously has secondary and tertiary effects. But that is not our primary purpose. On the basis of certain things that we do, whose primary purpose is financial and economic stability, there is nothing that we can do to prevent the secondary and tertiary effects which may or may not be socially appropriate from the point of view of values held by the Congress or particular segments of the Congress.

And I suggest that that is one of the reasons why we have a very significant amount of legislation which tends to address those questions. I just——

Representative Obey. This debate itself demonstrates that there are some very high stakes involved. And I really do think it is inappropriate to continue the absolute total budgetary unaccountability of perhaps the most powerful economic actor in the country. Let me ask you a different question.

What would be wrong with having the Secretary of Treasury and the heads of OMB and the Council on Economic Advisers, what would be wrong with having the law require them to sit down with the entire Open Market Committee three or four times a year?

Mr. Greenspan. I don't see why you need it as a law. If the Secretary of Treasury asks me, if he said he would like to have dinner with the Federal Open Market Committee on such and such a date, I would be delighted to set it up.

Representative Obey. Let me just say, I come from a small town area. I don't have a city in my district larger than 35,000 people. In the culture of communities like that, if you tell them there is no regularized process by which the managers of one branch of government get together and deal directly with the most basic economic issues facing this country, and that those decisions are done only informally and over dinner, they would tell me I was nuts. They would say that the system was nuts.

I am looking for a way without interfering with your legitimate needs to be independent intellectually and substantively, I am still looking for a way to make certain that the system itself is sending the right messages that the

Congress expects the Executive Branch and the Federal Reserve to be cooperative to a very intimate degree.

Mr. Greenspan. I understand your concern, Mr. Chairman.

Representative Obey. What I am leading up to is, what is wrong with something like the Hamilton bill? Senator Sarbanes, Congressman Hamilton and I have all sponsored versions of that legislation in the past, but this is the first Congress in which you are going to see that dealt with seriously.

Mr. Greenspan. Let me first state with respect to the Senator's bill, which he has pursued in a very straightforward and conceptual manner, that if the Congress were to pass that bill, it is very apparent that I and my colleagues at the Federal Reserve Board would have a very significant increase in power. And I say that as prelude to the fact that none of us are supportive of the Senator's initiative. And the question you have to ask us is, why?

Now, in this town that is a very unusual phenomenon. And the basic reason is that—and I assume I will have the opportunity to discuss it at the appropriate hearings that you will set up—it is our view that the system would change in a manner in which the capabilities of the Central Bank to do what Central Banks have to do, and which I think we do well, would be eroded. And I don't think that would serve the interests of the American people.

Representative Obey. By having to regularly and officially discuss economic matters with——

Mr. Greenspan. No, it is not that part I was referring to. I was referring to the issue of removing the presidents from the Federal Open Market Committee, which is a crucial change in the structure of our institution.

Senator Sarbanes. What is the public legitimacy that those presidents now have? They are selected by private interests, are they not?

Mr. Greenspan. They are selected by a board of directors of the individual banks with essentially the consent of the Federal Reserve Board.

Senator Sarbanes. The board never withholds that. Six of the nine directors are elected by the banks, isn't that correct?

Mr. Greenspan. That is correct.

Senator Sarbanes. And then they pick the president. Some of the presidents, on a rotating basis, go on the Open Market Committee and make very important public policy decisions, but they have no public legitimacy.

I may disagree with a decision that you and the members of the Federal Reserve Board may make, but I concede your public legitimacy. You were nominated by the President and the elected Executive Branch with political authority and confirmed by the Senate. You have, in effect, passed through a public screening in order to occupy that position.

There is no Central Bank in the world, in the advanced countries, at least, that I know about, that puts people on their Boards who are selected by private interests, even the Bundesbank, so reputed for its independent status. They are selected by the upper branch of the German parliament. They go through a public process that places public legitimacy.

We are getting the presidents of the Federal Reserve Banks by having them picked by other bankers. I can understand that, but they are selected by private interests and make very important public decisions. That is the essential rationale for that particular measure.

It is true that that would enhance the power of the Board of Governors, because you would then make the decisions made by the Open Market Committee. You might make decisions that I would strongly disagree with on the substance, but at least I grant the fact that you have been through a public screening that puts you in a position to make those decisions.

Mr. Greenspan. Senator, I would say, the basic concerns that we have, were we to reduce the authorities of the presidents of the Reserve Banks, is that it would eventually attract far less capable people, because obviously the role that they have in the Federal Open Market Committee is what crucially attracts them to the job, and we get extraordinarily good people as a consequence. It is——

Senator Sarbanes. How much do those bank presidents make?

Mr. Greenspan. It varies. Don't hold me to the specific numbers, but I think the range is from $150,000 to $250,000 a year.

Senator Sarbanes. To a quarter of a million dollars a year?

Mr. Greenspan. Yes. I would argue that every one of those people would make multiples of that in the private sector.

Senator Sarbanes. Some of them are fairly young when they get the job. They go to the private sector and get multiples, don't they?

Mr. Greenspan. It works both ways, I think.

Senator Sarbanes. It certainly does, but they get that benefit as well.

Mr. Greenspan. I don't think that is the reason they are able to do that.

Senator Sarbanes. They have no public legitimacy. The alternative would be to require their nomination and confirmation. That is another route that one might take. That would give them public legitimacy if you require that the Reserve Banks' presidents be nominated by the President of the United States and confirmed by the United States Senate, that is an alternative way to do it.

Mr. Greenspan. If you do that, you run into another very difficult problem. At the moment, Chairman Gonzalez' bill, which as you know advocates that, retains the power of the Board of Governors to dismiss any president, and indeed it is that power which enables the Board of Governors to essentially run the System.

If that occurs, then you have the dubious constitutional situation in which the President of the United States nominates and the Senate acquiesces to an individual who is then fired by the Board of Governors of the Federal Reserve System. And the problem that that creates is obviously intolerable, but the issue of removing that particular capability from the Board of Governors would make the ability of the Board to run the System, which is our statutory purpose, virtually impossible, because under those conditions——

Senator Sarbanes. That is not the approach I have taken. Mr. Chairman, I don't want to divert over on this issue, but if I could add one other line of questioning. When Professor Samuelson came before the Committee on December 30, he said:

> My probability estimates are that it [meaning the Federal Reserve] will let market interest rates tighten when and if the economy gains growth and momentum. For my sins, I deal with active money market traders all the time, and their explanation for the very steep Treasury yield curve, in

> other words, this contrast between short-term rates and long-term rates, is precisely their confident expectation that this is what the Fed is going to do. And I may say the Fed is right on target in its every statement, to wit the discussion of how the M2 targets should be changed.

Later, I asked Professor Samuelson the following:

> I want to be clear on one point with respect to this steep yield curve. As I understood your testimony earlier, making reference to the money traders with whom you have been in contact, the high rates on long-term securities, as you understand it from them, is attributable at least in part to their expectation that the Fed will tighten monetary policy in order to combat some inflation that they might see coming, or sort of conjure up as coming, as you begin to get a recovery. And therefore, given that position of the Fed, the long-term securities are staying at a higher rate. Is that correct?

Professor Samuelson answered:

> Yes, and it is incorrect in my experience that these smart people in the money markets see bottlenecks in the production process which is going to raise prices as soon as output rises, or see a resurgence of militant union wage activity. That is the explanation usually given.

Now, I think this is a very interesting point. In effect, I think it asserts that the Fed, by sending these hypersensitive signals about tightening monetary policy, is leading people to engage in a behavior that anticipates that policy, and therefore explains in part this steep yield curve.

We have a time now that by any rational judgment, the apprehension about inflation should be less now than at other times in our past. And yet the yield curve is, I take it, at the steepest it has ever been. I mean, you could only square this rationally if you could argue that the apprehension of inflation was the worst it has ever been—and that is clearly not the case—going back through the postwar period. You have had other periods of time when the apprehension of inflation was reasonably much greater than it is now, and the yield curve was not as steep.

It seems to me that lends credence to the point made that maybe a contributing factor to the steepness of the yield curve is a perception that the Fed is going to embark on this tightening policy and the interest rates are going to go up again.

Now, you know, the Fed's attitude and approach may be contributing to the very problem which the Fed asserts it doesn't want to see happen. In fact, I asked Mr. Hoskins the following question—your former Open Market Committee member out in Cleveland:

> Would you say it is accurate for a trader to look at the situation and calculated to himself, "Well, I just went home last night and I read the Federal Reserve Board and Federal Open Market release on the record of policy actions taken by the Federal Open Market Committee at its meeting on November 17, 1992, and the way I read that [this is a hypothetical trader talking] is that I think they are going to start taking these rates back up again, and that is what I think is going to happen. So I am going to play the game that way, I am going to expect these rates to go back up." Is that an irrational calculation on their part?

Mr. Hoskins answered:

> No, it is not. I cannot discount that as a possibility.

Now, what about that? I was very struck by that observation by Professor Samuelson, and when you start thinking about it, it seems to me to have considerable credibility. If there was a real basis for an apprehension about inflation, you might have a different situation, but as I pointed out earlier you have the best inflation record in 25 years.

But what the Fed is saying is, look, as soon as we get a little bit of growth moving here, we are liable to take these rates right back up. So they sit there and calculate, these rates are going to go right back up. We are not going to bring these long-term rates down because we will be locked into that long-term situation. The Fed, as soon as they get any basis on which to take the rates back up, that is what they are going to do. There we are. It is a Catch 22.

Mr. Greenspan. May I comment, Senator?

Senator Sarbanes. Certainly.

Mr. Greenspan. Thank you.

I have several problems with Professor Samuelson's notion. The first obvious one is that at the tail end of the yield curve is a 30-year bond. Our terms are 14 years, so he is obviously referring to some FOMC, quite distant from any of those who serve on it at this particular point.

Senator Sarbanes. Are not the bonds, their value is heavily weighted to the front-end, even the long-term bonds? Is not that correct?

Mr. Greenspan. That is correct. Let me come to grips with that issue. It is only partly the case.

The best explanation that one can have about why this yield curve exists is not that there is an inflation expectation about the short run. As I indicated in answer to an earlier question, the general judgment of the marketplace is that inflation in the next year or two is likely to be quite subdued, which raises the question, why then are the yields of 5-year, 7-year, 12-year, 20-year bonds so significantly elevated, and by any reasonable calculation have a significant inflation expectation in them?

Because, for example, a 10-year bond has an inflation premium built into it which is the average expected inflation over the full maturity of the debt instrument, that is 10 years. And what one must necessarily infer from that, in my judgment, is that while the markets do not factor in very much in the way of inflation expectations in the short run, they believe that this particular period, which we are currently going through, is an aberration, and their belief is that on the basis of aggregate policy, most specifically fiscal policy, at some point down the road, inflation will reemerge, and they have embodied that in the marketplace.

Senator Sarbanes. Let me put an alternative hypothesis to you. I am sitting in one of these luxurious boardrooms up there on Wall Street and I say, I don't think we are really going to have a problem with inflation, but Greenspan and his gang at the Fed, as soon as we get a little bit of growth, they are going to start raising the interest rates. They will say, Why are they going to raise the interest rates if there is not going to be an inflation problem? They are so hypersensitive to this issue, they are simply going to jump like a cat at any sign; they are going to jump even if there is no sign.

You had a meeting in November talking about tightening the interest rate. We are getting the best figures on prices both around and subsequent to that meeting than we have gotten in 25 years.

So I say, there is not going to be an inflation problem. But regardless, my calculation is that this outfit at the Fed is going to take interest rates back up again and I am going to operate off of that premise. What is irrational about that?

Mr. Greenspan. To answer——

Senator Sarbanes. The only irrationality would be if you are not going to do it. Are you not going to do it?

Mr. Greenspan. Senator, I am not going to answer monetary policy questions now, as you well know, and I regret that I can't get into this dialogue, but I must say I would like to, but I can't.

Senator Sarbanes. Thank you very much, Mr. Chairman.

Representative Obey. Mr. Greenspan, we are out of time. Thank you very much for coming. We appreciate it.

[Whereupon, at 1:05 p.m., the Committee adjourned, subject to the call of the Chair.]

SUBMISSIONS FOR THE RECORD

WRITTEN OPENING STATEMENT OF REPRESENTATIVE ARMEY

As a matter of record, I am here today to note that no House members have yet been appointed to the Joint Economic Committee, nor has an organizational meeting of the Committee yet occurred. In other words, the JEC has no house members, and it is simply inappropriate for the committee to be conducting business. This is yet another example of how much respect the Democrats pay to the rules of the house. We should wait for our house members to be named before holding rump hearings.

This aside, I hope you would address the issue of Federal Reserve accountability this morning, Chairman Greenspan. The relationship of the Federal Reserve to the Congress has been the subject of much discussion and legislation in the last few years. A number of bills have been introduced with the effect, if not the intent, of increasing congressional influence over Federal Reserve policymaking. The record suggests that this would be a great mistake.

Whatever may be said about imperfections in Fed policy, there is every reason to believe that congressional meddling would only make the situation much worse. After all, Congress has established a track record in exerting influence in the financial sector, and we know that this influence was often exerted in improper ways. Congress helped to create the half a trillion dollar S&L disaster that we are still cleaning up after. Prudence suggests that we should finish undoing this damage before laying the groundwork for a new debacle in the financial services industry.

It is increasingly clear that the task of implementing a coherent economic policy is going to be left to the Federal Reserve in coming years. Mr. Clinton, after falsely condemning the Republicans for raising the taxes on the middle class, now is proposing to do exactly that despite his promises to cut their taxes.

Nonetheless, during the campaign Mr. Clinton stated his view that Federal Reserve policy had been about right. In light of his statement, why all the recent Democrat Fed bashing? It would appear that the Democrats have so little confidence in the ever changing economic policy of this Administration that the Federal Reserve is needed as a scapegoat. As the economy is buried in new taxes on the middle class and onerous regulations, a convenient whipping boy will be required. Chairman Greenspan, I don't envy your new role in our government.

WRITTEN OPENING STATEMENT OF SENATOR SARBANES

I am very pleased to join with Congressman David Obey in welcoming the Chairman of the Board of Governors of the Federal Reserve System, Alan Greenspan.

Last year was not a good year for American workers and their families. It started with unemployment at 7.1 percent, it ended with unemployment at 7.3 percent and unemployment stayed above 7 percent all year. The average number of people unemployed each month was 9.4 million, which means that 23 million people or more were jobless at least once sometime during the year. In addition, there were more than 1 million people who were so discouraged by the lack of jobs that they simply gave up looking for work, plus 6 million who worked at part-time jobs because there were no full-time jobs available.

According to the National Bureau of Economic Research, the economy has been in a technical "recovery" since March of 1991. GDP is rising, but only one-third the rate of previous recoveries, and that is too slow to create jobs. The unemployment rate for December was five-tenths of a percentage point higher than at the recession trough in March, 1991. While economists may call this a recovery, to the worker it is still a "jobs recession".

The principal economic task facing the country now is to achieve a rate of growth fast enough to make real and substantial progress on the jobs front. To achieve this, we will need economic policies which focus on strengthening the pace of recovery.

I have become very concerned recently that monetary policy may not be adequately supportive of recovery in the labor market. At the last meeting of the Federal Open Market Committee, members of that Committee indicated considerable support for a lower target for money supply growth in 1993:

> During the discussion, the members generally agreed that developments since mid-1992 had reinforced the case for some reduction in the 1993 range for M2, and they indicated that they probably would support proposals for a lower range.

Lowering the target for money growth implies that the Fed is content with the anemic rate of growth that we have had so far in this recovery.

I find it incredible that the Fed would consider lowering its targets for monetarygrowth, in light of the growing consensus among economists that slow growth of the money supply over the past several years has been a major factor producing the current jobs recession.

Last February, the Federal Reserve set a target range of 21/2 to 61/2 percent growth for the money supply during 1992, with a goal of reaching the midpoint of 41/2 percent. For most of this year, however, money growth failed to reach even the lower target. Since the trough of the recession, the real money supply has actually fallen, in contrast to past recoveries when the Fed aggressively expanded the real money supply by 6 to 16 percent and fostered much stronger economic growth.

Experts from both sides of the political spectrum agree that money growth has been too slow, and monetary policy too tight, for much of the recent past. On December 30, the Joint Economic Committee held a hearing on the conduct of monetary policy, and heard similar testimony from two of the nation's foremost economists. Professor Paul Samuelson of MIT, who won the Nobel Prize in Economics in 1970 -- the first American ever to be awarded that prize -- told the Committee:

> Monetary policy in 1992 missed an important opportunity to lean against the wind of a continuing American growth-recession. Economic history textbooks of the future will attribute George Bush's defeat and William Clinton's victory to Federal Reserve actions which, from mid-1990 to mid-1992 were repeatedly too little and too late.

Professor Paul McCracken of the University of Michigan, a former Chairman of the President's Council of Economic Advisers, testified:

> The management of U.S. monetary policy thus far in the 1990s will not go into the annals of central banking as a distinguished performance. It has been inappropriate for the economic conditions of the country.

There is absolutely no justification for a downward revision in monetary targets at this time. Inflation is both low and stable, and there is no evidence of impending acceleration. The inflation rate in 1992 was the lowest in the last 25 years but one. If anything, the current jobs recession and the current problems in the financial system argue for faster growth in the money supply, not slower. Following the Fed's suggestion that we lower our targets for money growth would only compound the policy mistakes of the past, and condemn millions of Americans to continued unemployment.

It would be a sad irony indeed for the country to have voted to end the gridlock in economic policy between the Congress and the President, only to find it replaced with a new gridlock between an Administration and Congress committed to stronger growth and a Federal Reserve determined to restrain growth by keeping its foot on the monetary brakes.

PREPARED STATEMENT OF THE HONORABLE MR. GREENSPAN

Mr. Chairman and Members of the Committee, as you know, the Federal Reserve will submit its semiannual report on monetary policy to the Congress in just a few weeks, after our upcoming Federal Open Market Committee meeting. At that time, I will be in a position to address more specifically our expectations for economic growth and inflation, and the ranges of money and credit expansion that we anticipate to be consistent with the achievement of our goal of maintaining maximum sustainable growth in the economy, by fostering a stable, noninflationary, financial environment. Under the circumstances, my opening remarks this morning will focus primarily on identifying the major tendencies visible in our economy today.

The available data suggest that economic activity has been increasing at a firmer pace of late. After rising at only about a 1-1/2 percent annual rate, on average, over the first five quarters of the expansion, real gross domestic product increased at about a 3-1/2 percent rate in the third quarter of 1992. The advance estimate of the Bureau of Economic Analysis for fourth-quarter growth, which will be released tomorrow, is expected by many analysts to show a substantial gain as well. Meanwhile, industrial production posted a healthy advance over the final three months of 1992, with solid growth for a broad range of industries.

The recent news on the inflation front also has been quite favorable, as businesses have continued their efforts to contain production costs and boost efficiency. All told, the increase in the consumer price index excluding food and energy--a measure that is widely used as a rough proxy for the underlying trend of inflation--was just 3.3 percent over the twelve-month period ending in December, a full percentage point less than during 1991.

Although a number of economic indicators are distinctly encouraging, this is not to say that we have clear sailing ahead. As I indicated when I appeared before this Committee last March, households and businesses have been struggling to redress structural imbalances unparalleled in the postwar period. The speculative bidding up of real estate and other asset prices over the course of the 1980s fostered an excessive accumulation of debt and assets. The subsequent weakening of asset prices in the early 1990s left the balance sheets of many households and businesses strained with debt overload. Banks and other intermediaries that had financed the buildup suffered losses that severely eroded capital. The pressures to work down debt, reinforced by understandably more conservative lending practices, slowed economic growth. Some time ago, I likened these pressures to head winds of 50 miles per hour.

Those head winds have now slackened somewhat. But they have not disappeared. The process of balance sheet adjustment, while becoming less of a restraint on the economy, will doubtless be with us for some time. In addition, we are coping with a sizable retrenchment in the area of national defense. And, although U.S. domestic demand appears to be improving, many of our key trading partners are experiencing disappointing economic performance. This is acting as a drag on our exports and our outputs.

Much of the strength suggested by the incoming U.S. data has been in the consumer sector. The speed-up in consumption comes after a period of more conservative spending behavior, when many households seem to have focused on paying down debts and shoring up balance sheets, so badly pressured by the events of recent years. The relative strength of spending, thus, may reflect the improvement that has been achieved to date in the financial health of households. Debt-to-income ratios have fallen slightly, and debt servicing burdens have declined quite noticeably, in large part because of the reductions in interest rates. At the same time, the value of household financial assets has been buoyed by the rise in stock prices last year. Moreover, concerns about housing prices, which probably were a key reason that consumers were so distressed for much of the past few years, seem to have lessened.

The strengthening of the housing market also may be important in a more specific way. Sales of single-family homes have picked up and when existing homes are sold, the capital gains that usually have accumulated over time can be realized. The buyer of the home typically takes out a mortgage greater than that paid off by the seller. The difference largely reflects the realized capital gain of the seller who receives unencumbered cash, only part of which is apparently added to a down payment on a subsequent home purchase. Such cash provides the seller with additional liquid funds to spend on consumer goods and services.

History suggests that this is just what has been happening. The marked rise in existing home sales in recent months has added to households' purchasing power by enabling them to realize capital gains at an increasing rate, helping to fuel the growth in consumer spending. Homeowners also have an opportunity to liquefy capital gains when refinancing an existing mortgage, and refinancing surged in the latter part of 1992. Realized or liquified capital gains are not taken account of in computation of the official saving rate, whose recent decline therefore probably overstates the drop in the flow of saving as perceived by households. However, unless home sales, mortgage refinancing, and the associated equity extraction continue to rise, there is a limit to how much longer this factor can fuel the growth of consumer spending. The measured personal saving rate is at a relatively low level, and further outsized increases in consumption are not very likely in the absence of a sustained pickup in income growth.

Consequently, a significant consideration, in terms of the outlook for consumer demand, is the employment picture. The optimism revealed in the recent surveys of consumer attitudes may prove fleeting if overall labor market conditions remain subdued. Indeed, despite signs of modest improvement in the past few months, since the recession trough in March 1991, employment has shown essentially no net change on the payroll basis, and only a modest increase in the household series.

Of course, the softness in employment in the current expansion is partly the counterpart of another development--namely, a dramatic improvement in productivity. Since the recession ended in early 1991, productivity has grown at an average annual rate of about 2-1/2 percent, a better than expected performance given the relatively slow pace of the economic recovery to date.

The corporate restructuring and downsizing efforts that have been associated with the recent productivity gains have in part been a response to the profit squeeze that emerged during the 1990-91 recession. They also have been spurred by increasing costs of health insurance and other fringe benefits, which have restrained hiring and encouraged a surge in the use of temporary workers. But restructuring also seems to have reflected an effort to capitalize on new opportunities for greater efficiency. Although we cannot be sure how or why these new opportunities have arisen, I suspect they are the product of the accelerating advances in computer software and applications. Past large accumulations of computer hardware did not seem to have the expected effects on productivity. But a new synergy of hardware and software applications may finally be showing through in a significant increase in labor productivity.

These far-reaching changes in the production processes in manufacturing, and in the means by which services are produced and distributed, have apparently yet to run their course, though one must assume that the pace of restructuring will surely slow. Accordingly, we may see less of a tapering off in productivity gains in coming quarters than past cyclical experience would suggest. That prospect is highly favorable in terms of the longer-run potential output of the economy and our international competitiveness, but it would also imply some continuing adjustments in the work force in the near term.

The push to acquire state-of-the-art technology has also been providing a discernible thrust to capital spending in recent quarters--and likely will continue doing so. Real outlays for office and computing equipment have soared, as firms continue the transition to the more powerful and cost-effective machines that are now available, and purchases of communications equipment continue to be boosted by, among other things, the shift to fiber-optic networks. Demand for other, more traditional types of equipment now appears to be growing as well. The improved pace of economic expansion has doubtless lifted sales expectations, and the marked increases in profits and cash flow over the past year are providing funds for new purchases.

Problems, however, remain in a number of areas, though with some lessening of concern. Chief among them are the ongoing difficulties in the credit area. Depressed demand is doubtless the major explanation for weak loan growth at banks and many other intermediaries. However, increased regulation presumably has also played a role. Moreover, lenders, seeking to protect their capital positions, have been extremely cautious. Although they seem to have stopped tightening credit terms, a significant easing is not yet evident.

Commercial real estate has accounted for much of the asset quality problems at financial institutions. Until real estate values clearly stabilize, banks and other intermediaries are not apt to become substantially more eager lenders. The liquidity of real estate markets remains impaired, and lenders are uncertain about the value of collateral and the appropriate level of reserves against nonperforming loans. The risk that further reserving may be necessary has led banks to bolster book capital, widen lending margins, and approach new credits with caution. It is not necessary for real estate values to rise to reduce this risk, but lenders need to be more confident that prices will not continue to fall and that, if necessary, they can sell collateral expeditiously at reasonably predictable prices. While there are some initial signs that commercial real estate markets in some regions are finding a bottom, uncertainty remains high. Having accumulated substantial liquid assets and rebuilt capital, banks seem well positioned to meet increased loan demand, especially once collateral uncertainty diminishes. Endeavors by both the Resolution Trust Corporation and private parties to encourage the development of a secondary market in commercial mortgages will help liquify the market in commercial real estate itself. However, should problems in commercial real estate persist, credit conditions for small and riskier business may ease only gradually for some time.

Soft property prices, engendered by high vacancy rates and sluggish demand for space, are likely to continue to restrain commercial construction spending in 1993, and the prospects for multifamily housing are not much better. In addition, budgetary pressures on state and local governments remain intense.

Meanwhile, we must continue to work through the sizable adjustment in military spending that has been under way since the late 1980s. From a longer-run perspective, the defense cutbacks carry the anticipation of substantial benefits for the U.S. economy. By freeing up resources that can then be devoted to improving the nation's stock of productive physical and human capital, they should ultimately lead to higher living standards. In the short run, of course, lower defense spending is a depressant on economic activity, and on jobs and incomes. For industries and regions that rely heavily on military spending, the dislocations may well be sizable. In industries that depend on defense expenditures for at least 50 percent of their output, employment has fallen more than 20 percent (300,000 jobs) since 1987. And, in California, where the share of civilian employment in defense-related jobs may be almost twice the national average, the unemployment rate has risen to about 10 percent, nearly 3 percentage points above the national average.

In addition, our export performance is being restrained by developments abroad. Countries that earlier had been growing at least moderately have shown clear signs of slower growth, or outright declines, in economic activity. In both Germany and Japan, real output fell for part of 1992, and growth for the year as a whole was substantially less than in 1991. Many of the other countries of continental Europe have recorded only weak growth. And in Canada and the United Kingdom, signs of recovery from prolonged recession have ranged between weak and elusive.

Foreign officials have reacted to these developments with measures intended to boost spending and to promote recovery. In Japan, official interest rates have been lowered nearly 3 percentage points since the start of 1991, and a supplementary budget of additional government spending has just been passed. In Germany, the choice of policy steps has been complicated by the special circumstances associated with the massive task of unifying the economies of eastern and western Germany. Monetary conditions have been eased somewhat, but continued rapid money ? growth and persistent inflation have made officials cautious. In the other European countries tied to Germany through the exchange rate commitments of the European Monetary System, scope for aggressive monetary easing has been limited. This has led some countries to relax that commitment, at least for a time, and to ease monetary policy.

I will, of course, be discussing Federal Reserve monetary policy in detail when I present the System's Humphrey-Hawkins Report to the Congress next month. However, let me comment briefly on an issue that has arisen recently with regard to the ranges for monetary growth in 1993. The issue, as I indicated in my letter to Senator Sasser earlier this month (attached), is that an unusual portion of aggregate. spending has continued to be financed by credit granted outside of banks and other depositories--evidently a side effect of the process of the balance sheet restructuring that I referred to earlier. Should the phenomenon persist in 1993, it implies that growth in M2 consistent with our broader economic objectives would be slower than indicated by normal historical relationships of money and spending--and that a technical adjustment to our monetary growth ranges might thus be in order. That assessment is wholly technical and should not be interpreted as indicative of any change in monetary policy per se. Partly in view of these developments, the Federal Reserve can not rely exclusively on money supply growth relative to its targets in formulating monetary policy. In any event, the Federal Open Market Committee will reexamine this issue, along with other, broader considerations, when it meets next week to set monetary policy goals for 1993.

Regardless of the specific ranges established for the growth of money and credit over the coming year, the objectives of monetary policy remain unchanged: We are seeking to foster financial conditions that will encourage maximum sustainable growth in the economy. As I, and my colleagues, have stressed, a noninflationary environment is a precondition to such a goal. For the coming year we will continue playing a constructive role in supporting an extension of the recent more hopeful signs of solid growth, while endeavoring to avoid any excesses that might lead to a flare-up of inflationary pressures down the road. Such a course will help the economy emerge from the financial difficulties of recent years, maintain the progress toward price stability that has been achieved thus far, and thereby promote a sustainable economic expansion.

ATTACHMENT TO THE HONORABLE MR. GREENSPAN'S TESTIMONY

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

ALAN GREENSPAN
CHAIRMAN

January 8, 1993

The Honorable Jim Sasser
Chairman
Committee on the Budget
United States Senate
Washington, D.C. 20510

Dear Mr. Chairman:

I appreciate having your views on the Federal Reserve's M2 money supply target for 1993. I want to emphasize that the issues I was addressing in my letter to Chairman Gonzalez were wholly technical in nature. In discussing possible reductions in the ranges, I was not signalling any lessening in the Federal Reserve's commitment to fostering financial conditions most conducive to the sustained expansion of the U.S. economy with the highest possible levels of employment and output over time. Nor was I endeavoring to indicate any change in monetary policy *per se*.

My observations were directed solely at the statistical problems we are having with our money supply aggregate measures, and their ability to appropriately track developments in the economy. That relationship is best represented by M2 velocity (the rate of money turnover, or nominal GDP divided by M2). This ratio increased substantially in 1992, despite continued declines in market interest rates, which usually are associated with falling velocity (see chart). Through the first three quarters of 1992 nominal spending increased at around a 5 percent annual rate, while M2 rose at only a 1-1/2 percent rate. A further increase is indicated for the fourth quarter of 1992.

We believe that these extraordinary increases in velocity reflect changes in the way spending is being financed. In response to the stresses of recent years, lenders and borrowers have taken steps to strengthen their financial situations. In the process, they have emphasized rebuilding capital, paying down debt, and raising funds in longer-term debt and equity markets. A side effect of this restructuring is that spending has been financed to an unusual degree outside of banks and other depositories, whose liabilities constitute the bulk of the monetary aggregates. As a counterpart, induced by higher yields, savers have channelled funds directly to borrowers via investments in longer-term debt and equity. This means that M2 and M3 as ways of financing economic activity are being replaced in part by alternative financing vehicles without impairing the economy's growth potential. The statistical result is that M2 and M3 velocities have risen; another is that we are making significant progress toward more comfortable financial conditions, which will help to support economic expansion. Still, it is unlikely that this process has reached an end, and its continuing influence on the statistically measured velocities of M2 and M3 will have to be taken into account by the Federal Open Market Committee when it considers the 1993 ranges in February.

I will be circulating your letter to the other FOMC members so they will be fully aware of your views when they consider the ranges at their next meeting. I am enclosing a staff study of M2 velocity behavior, and would be pleased to have our staff brief you or your staff on the technical reasons for the ongoing statistical increases in M2 velocity. I hope you have found these comments useful.

Sincerely,

(signed) Alan Greenspan

Enclosures

WRITTEN OPENING STATEMENT OF SENATOR CRAIG

MR. CHAIRMAN, I am pleased and honored to join you today as a new Senate member of the Joint Economic Committee. I have had a longstanding and intense interest in our nation's economic health in general. In particular, I look forward to exploring on this committee how our economy is affected by the fiscal and regulatory decisions made by the federal government. I also have had a longstanding interest in major sectors of our economy, such as energy, agriculture, health care, and trade. These sectors are important not only in the Northwest, but all across our nation.

I look forward to participating with my colleagues from both sides of the aisle and both chambers in full and far-ranging discussions of the perils and the opportunities that face our economy.

I want to join my colleagues today in welcoming Dr. Alan Greenspan to our hearing. Dr. Greenspan, you have had an accomplished and distinguished career in both explaining and influencing how the government affects the economy.

I note with interest that you toured for a year as a tenor saxophone player with the Henry Jerome band, after studying music at Julliard. I hope this is an positive omen of the music you and the new administration will make together. Given your commitment to economic growth, sound money, and deficit reduction, I hope you're the first chair in this new sax section.

I'm sure that you're going to talk to us today, in part, about the need to reduce the federal budget deficit. As you and we attempt to take an overview of the economic outlook, deficit reduction doesn't deserve special attention, it deserves preeminent attention.

Just yesterday, Dr. Robert Reischauer of the Congressional Budget Office told the Senate Budget Committee that the current, "lackluster [economic] expansion and large budget deficits are not merely coincidental. Living standards are projected to grow more slowly, in part, because of the decline in the national saving rate over the past decade. And the federal budget deficit had been a major contributor to that drop...."

He also said that, "Under current budgetary policies, the deficit will climb from $310 billion in 1993 to ... about $650 billion in 2003.... Federal debt would then represent almost 80 percent of GDP, higher than at any time since the aftermath of World War II." In the same vein, the General Accounting Office last year concluded that, if we complete the odyssey to a balanced budget by the year 2001, Americans' living standards will be about a third higher in the year 2020; but if we do nothing, the next generation will have a standard of living, at best, no higher than today's. I find such figures astounding and sobering. They make ever- clearer the need for this Congress to pass the Balanced Budget Amendment to the Constitution and send it to the states for ratification. Every time that Congresses and Presidents have grounded their fiscal resolve in a mere statute, it has dissolved as a matter of political inconvenience.

We came very close to passing the Balanced Budget Amendment last year and I believe we will pass it in the 103rd Congress. I'm convinced -- and a growing number of converts in and outside of the Congress are convinced -- that no lesser constraint will be effective in preventing us from, as Jefferson said, unjustly "saddling our posterity with our debts." I don't expect you necessarily to comment on such specific budget process reforms, but I do hope you will comment on these recent, bleak, deficit projections and on the need for deficit reduction as a precondition to substantial monetary stimulus of the economy.

Mr. Chairman, I also want to make the point that, as we examine various aspects of the budget deficit and the larger economic picture, there needs to be a thorough study of health care reform, Medicare, and Medicaid. I am concerned about the startling figures quoted by Dr. Reischauer in his testimony yesterday. He stated that Medicare and Medicaid represented 3.4 percent of GDP in 1992 and will grow to 5.1 percent of GDP by 1998. These figures are very frustrating. Our expenditures are growing quickly, yet health care providers in my state of Idaho continue to get reimbursed at below cost rates for many Medicare and Medicaid services. Health care reform is high on the public policy agenda; therefore, it is important that we have a good understanding of how current government involvement is affecting health care costs and access. We can not reform our system without this analysis and a better understanding of how we can provide access to those who are now in the ranks of the uninsured, without further contributing to the deficit. I believe it would be of vital importance for this committee to hold hearings in this area in the near future.

THE 1993 ECONOMIC REPORT OF THE PRESIDENT: REVITALIZING THE ECONOMY

THURSDAY, FEBRUARY 11, 1993

CONGRESS OF THE UNITED STATES,
JOINT ECONOMIC COMMITTEE,
Washington, DC.

The Committee met, pursuant to notice, at 10:00 a.m., in room 2359, Rayburn House Office Building, Honorable David R. Obey (Chairman of the Committee) presiding.

Present: Representative Obey and Senator Sarbanes.

Also present: Lee Price, Charles Stone, Glen Rosselli and Chris Frenze, professional staff members.

OPENING STATEMENT OF REPRESENTATIVE OBEY, CHAIRMAN

REPRESENTATIVE OBEY. Good morning. Today, the Joint Economic Committee is beginning a series of three hearings to examine the current state of the American economy and the economic challenges that confront President Clinton and his new administration.

For the benefit of the young people in the audience, I don't want you to think that because you don't see a lot of members of Congress here, it means they are slacking off. The fact is that Congress is in recess, and I simply stayed in town to run these hearings because I thought that Congress ought to be examining, in a public way, some of the same dilemmas which the President is examining as he makes his final decisions about the budget for the coming few years.

We now have a new President, and we have a very new Congress, with some 110 new members in the House and 12 new members in the Senate, and we have a country which is demanding change. Last night President Clinton listened to Americans talk about their hopes and concerns at a town meeting in Detroit, and as I said, over the course of the next few days, the President will be putting the final touches on the economic proposals which he will be presenting to the Congress in the State of the Union message on the 17th, and on his budget about a month later. And over the course of the next year, and probably for far longer than that, we will be engaged in a debate about what that change should be and what direction our country ought to take.

The purpose of these hearings is to try to paint a clearer picture of the current shape of the economy, the shape it will be in if we don't take action, and the options before us to make things better. Today and tomorrow the Joint Economic Committee will discuss these problems and issues, and the President at the same time will be making his choices.

I think the best way to understand the problem confronting us is to recognize that we really have four deficits which have afflicted our economic performance during the past 12 years, and in my view many of them afflict us going all the way back to 1973. I would like to use some charts before we hear

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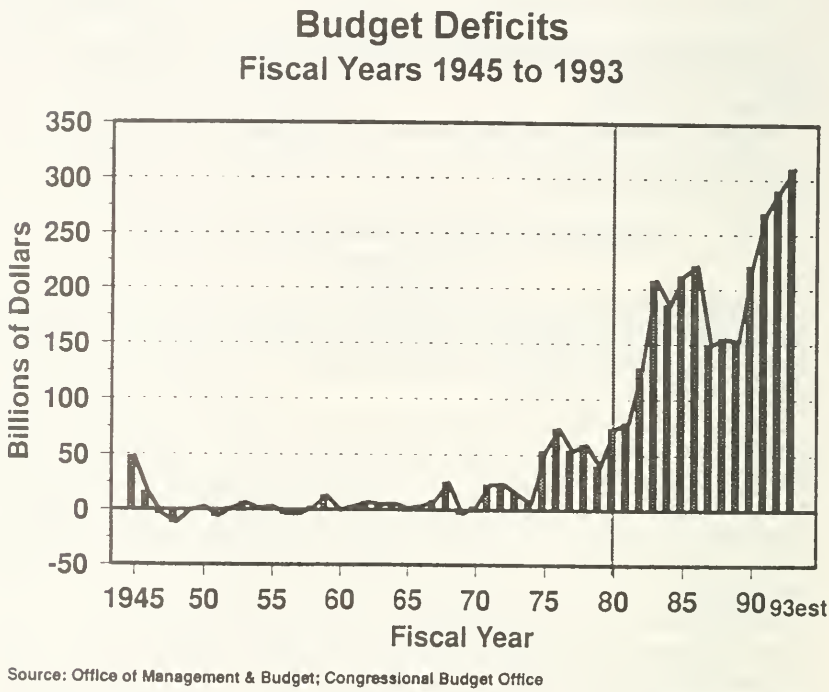
from our distinguished panel this morning. I would like to use them in order to try and demonstrate what those four deficits are all about. Before I do so, I want to make clear that these numbers and graphs are important only insofar as they tell the story of what is happening to real people in the real economy.

The first chart is the one that is most familiar to the general public, I think, and to most members of Congress. It demonstrates what has happened to the federal deficit since 1945. (See chart below).



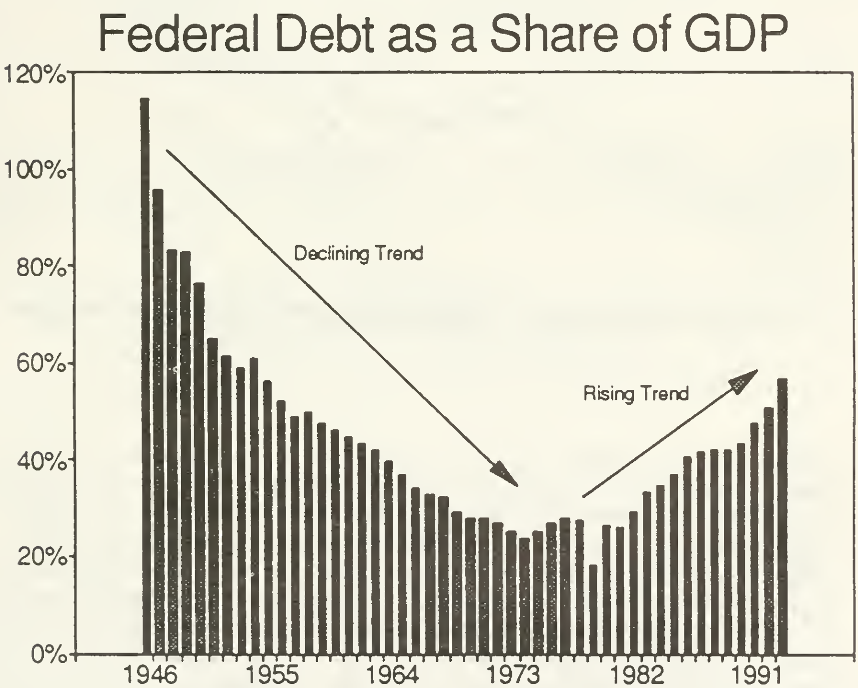
As you can see, going from 1945 on up through about 1980, we never had a deficit which exceeded a little over $70 billion. I will never forget, for instance, in 1980 when a number of congressional leaders met in Bob Byrd's office for three weeks, because we had been told by Paul Volcker, the Chairman of the Federal Reserve, that if we did not cut President Carter's deficit by $16 billion, the sky was going to fall and the world was going to come to an end, because we could not afford to have a deficit of $60 billion. Well, we cut $16 billion out of the deficit, but the deficit did not go down because the economy weakened.

I think there is a lesson in that for congressional and presidential policymakers as we proceed to tackle today's deficits. You can see up until 1980, we never exceeded $74 billion in deficits. You can see since that time that the nominal deficit has exploded.

Now, when we were at this point at the beginning of 1981, President Reagan proposed a plan to Congress, which he told us would eliminate the deficit in four years. That plan essentially consisted of doubling the military budget over a specific period of time. It also consisted largely of some very large tax cuts, especially for high-income people.

The green numbers on this chart demonstrate what we were told at that time by the Administration as to what would happen to the deficit if we passed the Administration's recommendations in 1981. The red lines indicate what the numbers actually wound up being in 1987, 1988, 1989 and 1990. As you can see, a considerable variance between the promise and the performance of the economy.

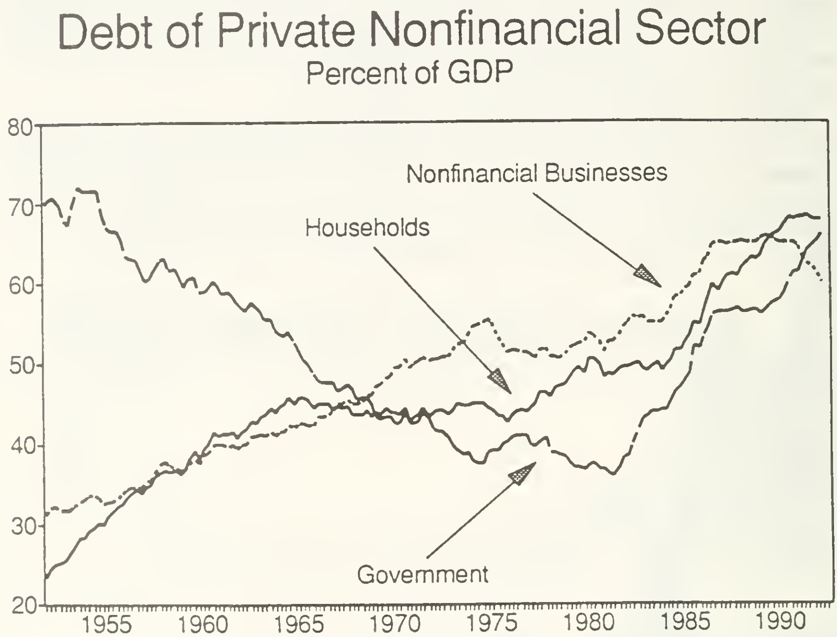
I believe that the most meaningful way to look at our fiscal situation is to take a look at the historical pattern of debt by the government, and this chart demonstrates that at the end of World War II, in 1945, we had a debt that exceeded the annual total national income of the United States. That declined steadily over a period of years until about 1973, and it got down to about 24 percent of our annual national income. (See chart below).



It stalled between 1973 and 1980, and then after the budget decisions in 1981, the percentage of our annual national income began to significantly rise again to a point where it has almost doubled the level where it was at in 1980.

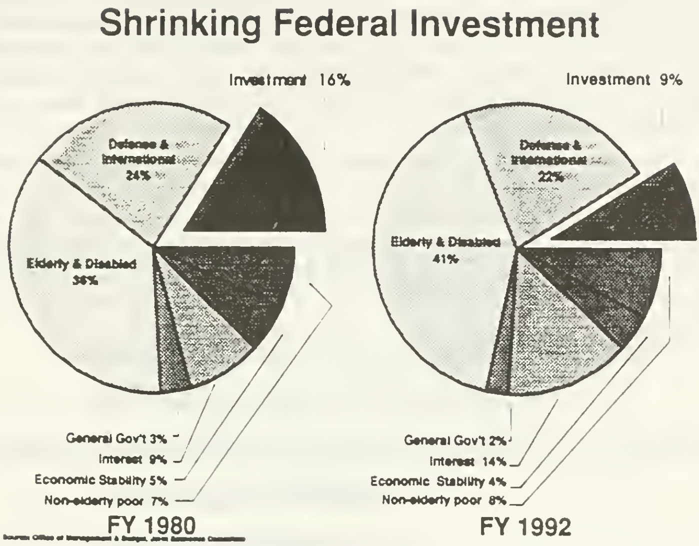
This next chart demonstrates that debt did not just increase in the governmental sector. This chart demonstrates that we had a significant increase in private debt, as well, in the economy during that same period. It was rising slowly between 1945 and 1980, and then it began to shoot off the graph in the

1980s, with serious consequences for us all. We also at that time, in international terms, went from having the rest of the world owe us large amounts of money to having us owe the rest of the world a good amount of money. (See chart below).

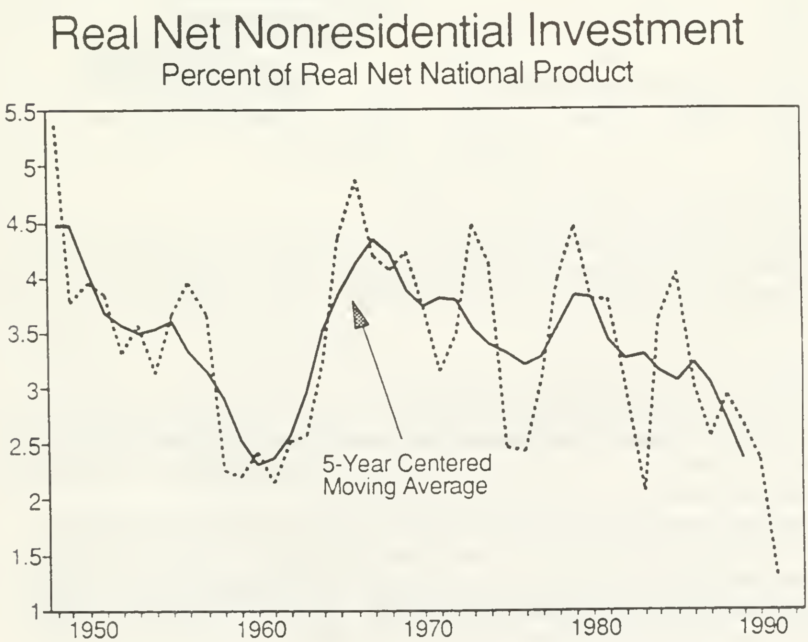


Now, that demonstrates what has happened on the issue of debt. This chart demonstrates that we have a second deficit which we also need to tackle if we are going to succeed in confronting the economic problems before us.

This chart demonstrates that in 1980 the investment share of the federal budget—and by that I don't mean consumption items—I mean what we invest in children by way of an education, what we invest not in health care but in health research, what we invest in science research to stay at the cutting edge of technology, what we invest in physical infrastructure to create the kind of physical grounding that is needed for communities to prosper. This demonstrates that if you break up the budget into those kinds of categories, the investment portion of the budget, represented by this green piece, declined from 16 cents out of every federal budget dollar in 1980 to about nine cents out of every budget dollar at the end of the decade. That is more than a 40 percent decline. And I think that this deficit in investment—this disinvestment, if you will—is every bit as significant to our economic problems as is the federal budget deficit which gets so much attention. (See chart below.)

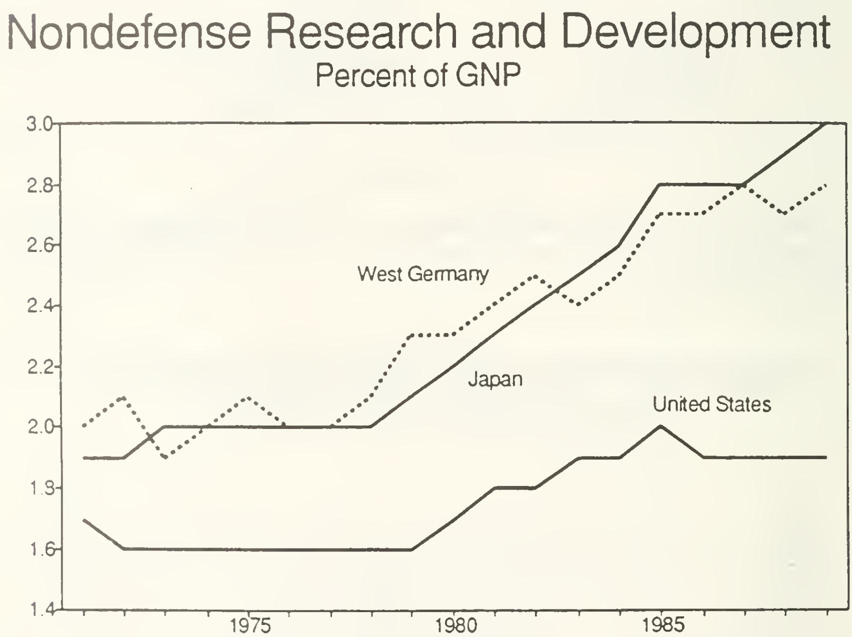


And, again, this next chart demonstrates that that disinvestment did not just occur in the public sector. It has occurred in the private sector as well. (See chart below.)



It is hard to follow a chart which moves around as much as this has, but what this line is meant to represent is what the average net investment was in this country between 1946 and 1988, riding at somewhere between 6 and 7 percent. It has really dropped off the graph since that time, and I think this indicates that you simply had a strong worsening of what had been a slight downward trend up until that time.

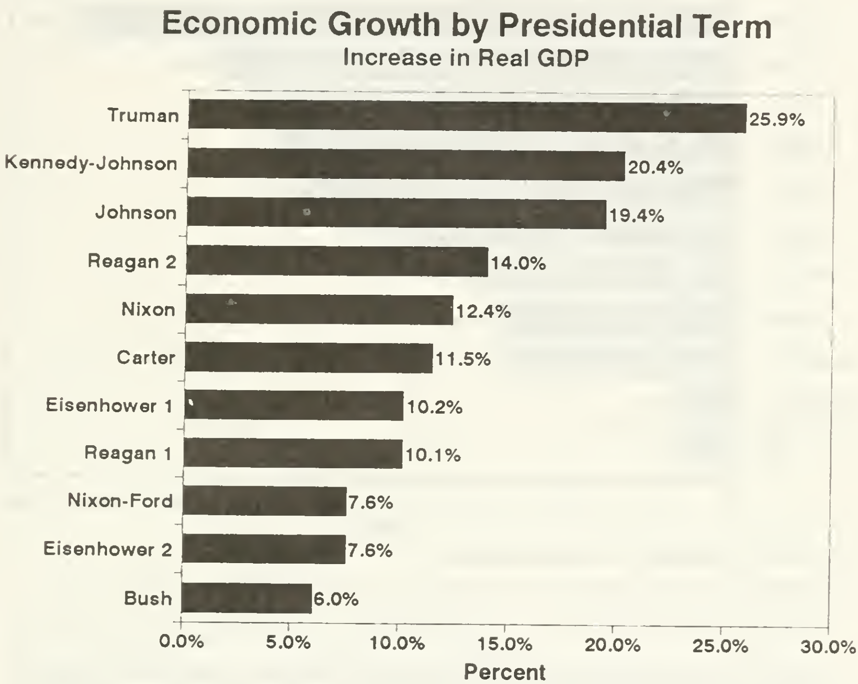
Now, if you take a look at nondefense research and development, this is a percentage of our total income each year, you see this blue line represents the investment trend in Germany and in West Germany, and as you can see it was rising from about 2 percent of Gross National Product to almost 2.8 percent today. As you can see, Japan has had a steady rise in their investment as a percentage of their national income starting in 1979, just a steady rise. (See chart below.)



The United States, a slight rise between 1980 and 1985, but as you can see, a much smaller effort than their economic competitors. And over time, in my view, and I think in the view of most people, we are going to pay a significant price for that gap.

Now, so much for the investment deficit. We also have a third deficit, in my view, and that third deficit is what I would call a growth deficit. This chart has arranged the historical growth of the American economy in descending order by each President's four-year term. (See chart below). And as you can see, in Truman's only full term, real economic growth was about 25 percent.

Now, that was due in very large part to the pent-up energies at the end of World War II, but under Kennedy and LBJ—it was Jack Kennedy's first term, which Johnson completed after Kennedy was assassinated—you still had very rapid economic growth. In Johnson's second term, the same thing occurred. In part that was added to because of the Vietnam War. We had very strong growth in Reagan's second term. Then Nixon's first term comes after that in terms of growth.

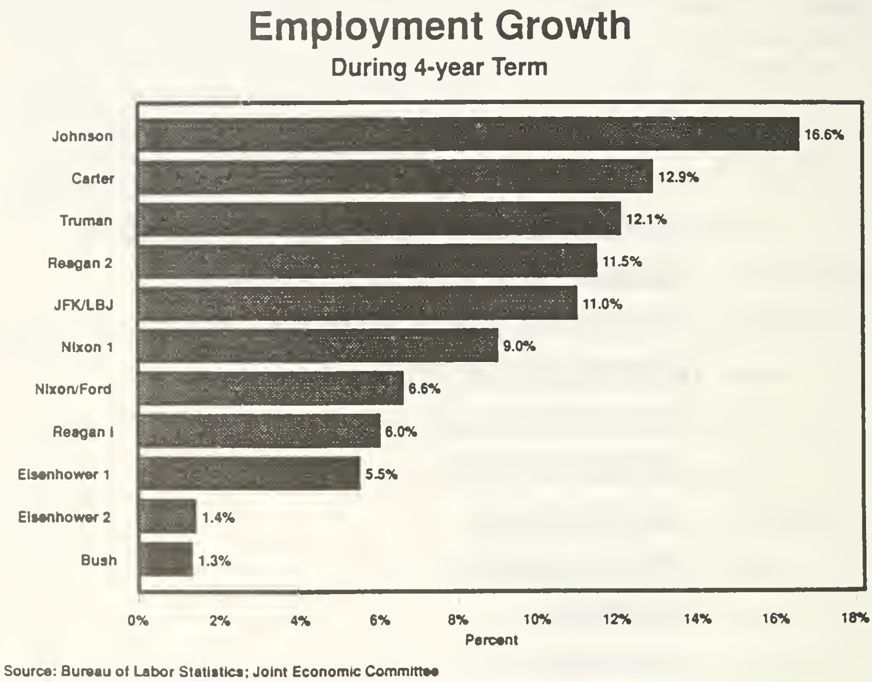


In descending order, before the Bush four-year period, the lowest period of real economic growth occurred under Dwight Eisenhower. And as you can see, we have been trailing the pack for the last four years. That has resulted in this pattern for employment growth.

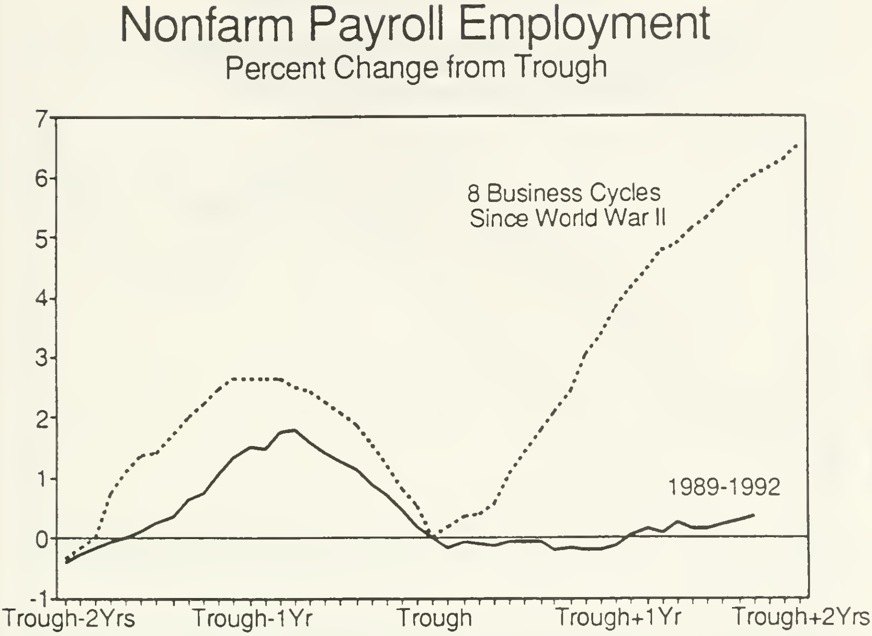
Again, this chart is arranged in descending order showing that you had the fastest growth in jobs in any four-year period under Johnson, over 16 percent growth in jobs during his four-year term. Carter's term was the next largest job growth period. Truman's term was the third largest. Reagan's second term produced 11.5 percent growth in jobs.

You can see, again, before the last four-year period, the slowest job growth period was under Eisenhower, both his first and second term, and again the last four years trailing the pack.

This chart demonstrates what has happened in jobs in a little different way. The blue line—and this has been used by Senator Sarbanes many times—represents the average of the eight previous recoveries from recession in terms of job growth. (See chart below).

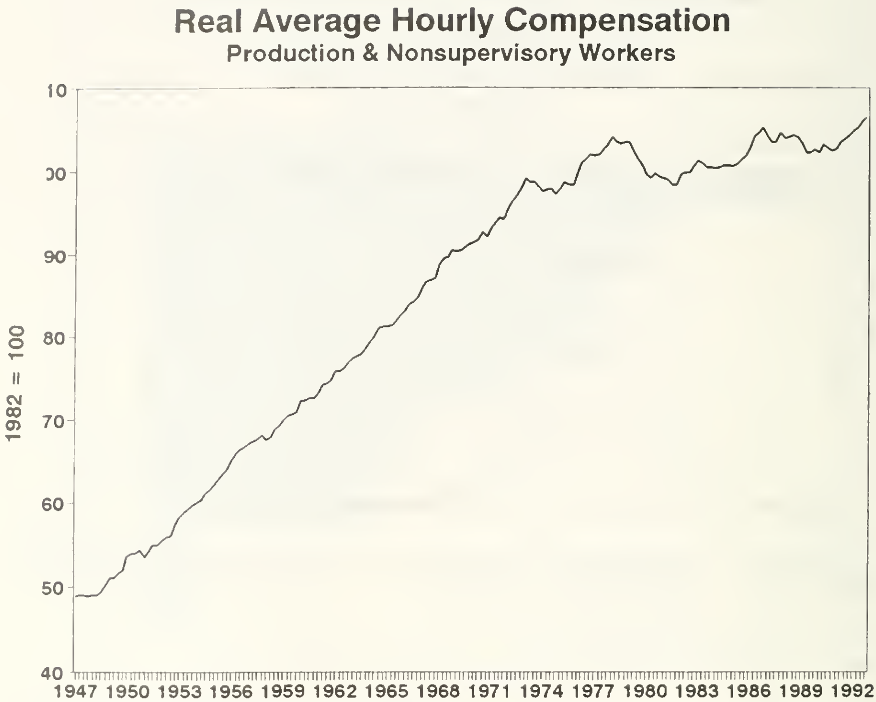


What this chart demonstrates is that some 22 months after we hit bottom in the eight previous recessions, we had recovered all of the job loss that had occurred and were on our way to creating a good number of healthy jobs. Whereas in the current recovery, there is barely any recovery at all in terms of job growth, and that indicates that while we may have some promising signs in terms of some of the economic indicators but in terms of that progress being translated into real progress for families looking for work, we have not had very much progress. So I think this shows what has happened with what I call the growth deficit. (See chart below).



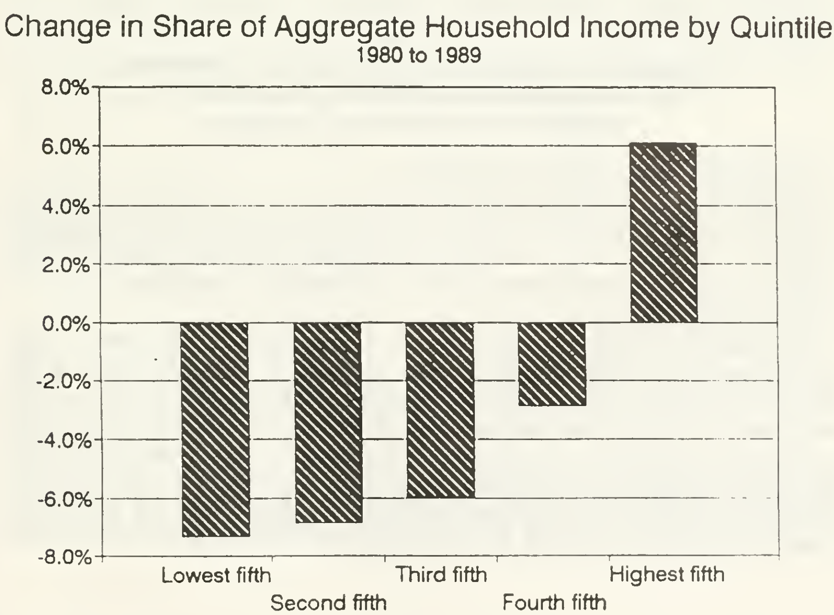
Because of all of these factors, you also have an income deficit to American families. This chart represents what happened to real hourly compensation for all workers in our society going back to 1958.

This chart demonstrates what has happened to the real level of compensation for all workers when you include both wages and fringe benefits, and it shows that in the early 1970s or mid-1970s, we stalled out, climbing rapidly up until that time. And we stalled out at that point and have been trying to move it up since, but haven't really gotten it there. (See chart below).



Now, when you take a look at the next chart and you take fringe benefits out so that you are only looking at compensation for workers in this economy who are not managers, you can see that we have had a significant decline in average hourly earnings at about $7.80, but not quite. In 1980, it dropped significantly, got back up to that point in 1986, and since then it has been declining. So I think what that demonstrates is that the country as a whole has been in big trouble in terms of average hourly earnings, certainly for the last six years, and I believe the problems began as far back as 1973. (See chart below).

This chart demonstrates that the squeeze on income has not fallen evenly on families or on workers. This chart demonstrates the change in the share of total national income from 1980 through the end of the decade, and as you can see, the bottom fifth has a significant decline in their share of national income. The next bottom fifth also had a significant decline. (See chart below).



You don't reach a point at which people improve their share of national income until you get to people who are in the top 10 percent of income levels in this country. At this point, once you get here, above the 91st percentile, you begin to see an increase in those worker's share of national income, and the people who have really cleaned up are the people in the top 1 percent. They have had almost a 40 percent increase in their share of national income over the past 10 years.

I think those charts pretty much tell the story. People may quibble with some of them, but I think those charts in the main tell the story about what has happened in this country on the four deficits which President Clinton will be wrestling with: The budget deficit, the investment deficit, the growth deficit, and the family income deficit. And the purpose of these hearings is to try to get some advice this morning about how we might go about attacking these four deficits as the President puts together his budget and economic proposals, and as the Congress considers those proposals.

I think that we have to remember that in the end, economic growth is not an end, in and of itself. Economic growth is simply a way by which we can assure a higher standard of living and a better and more fair and a more decent society for all of our people; it is an instrument rather than an end in itself. The purpose of these hearings is to try to make clear that there is more than one problem to solve and to try to get some good advice on how to solve them.

And with that, let me simply ask our three distinguished guests to give us their best advice this morning.

We have with us Professor James Tobin, Department of Economics, Yale University, a Noble Laureate in Economics; Professor Robert Solow, Department of Economics, Massachusetts Institute of Technology, also a Noble Laureate in Economics; and Professor Allan Meltzer, Graduate School of Industry, Professor of Political Economy and Public Policy, Carnegie Mellon University.

Gentlemen we are happy to have all three of you here, and why don't we begin with Mr. Tobin.

STATEMENT OF JAMES TOBIN, PROFESSOR OF ECONOMICS, DEPARTMENT OF ECONOMICS, YALE UNIVERSITY; AND NOBEL LAUREATE IN ECONOMICS

Mr. Tobin. Thank you, Mr. Chairman.

I submitted, as a statement to the Committee, my talk at the Little Rock Economic Conference in December. I am not going to read that, although it explains my general point of view on the problems you were speaking about just now. I have also made available a set of charts that I am going to refer to in my oral remarks.

I was here at a similar hearing just about a year ago. At that time, I advocated a macroeconomic stimulus to get a vigorous recovery going, and at the same time I advocated making provisions for deficit reduction which wouldn't come into effect until the economy was well along in the recovery two or three years later. I stressed the importance of encouraging both private and public investment, and I stressed that any fiscal stimulus in the short run needed for increasing demand and invigorating the recovery should take the form of investment outlays that would do good things for the quality of jobs and for future standards of living. Those investments would be both private and public.

For that reason, I recommended at that time an investment tax credit, a revival of that investment incentive, and a program of fiscal assistance to state and local governments where much-needed public investments in infrastructure and education could be implemented. I recognized at that time that expansionary monetary policies may not be as potent as in previous business cycles, but I urged the Federal Reserve to lower further the interest rates over which it has immediate control. And I suggested that both the Federal Reserve and the Treasury take actions to reduce the stocks of long-term federal securities in the hands of private investors. Those proposals were similar to ones that were being offered at the same time by Senators Sarbanes and Sasser and also advanced somewhat earlier by my fellow witness today, Robert Solow. In March 1992, Mr. Solow and I, along with other economists, wrote an open letter to Congress, to the President and to the Federal Reserve Board of Governors, along the same lines as I just outlined. We obtained the support of 100 economists for that package. It is also the kind of program I was arguing for in my statement in Little Rock in December, in the paper that I have submitted to the Committee. I still support that program, and I want to explain why.

I realize that economic news in the past couple of quarters has been better, much better, than it had been through most of 1992, and indeed through most of 1989 to 1992, for that matter. As a result, many people now reject any further stimulus from either monetary or fiscal policy, and would make deficit reduction the highest and even the more immediate priority. Some economists have said that deficit reduction expected in the future would be a sufficient stimulus for bringing about recovery now. I think that puts things upside down.

You said in your introductory remarks, Congressman Obey, that economic growth is not an end in itself but a means of implementing higher goals for the society, and I agree. I also think that deficit reduction is not an end in itself but is a means to produce economic growth in the future and to improve the standards of living of our children, grandchildren and their grandchildren. But if deficit reduction is undertaken at the wrong time, the things that you have to do to obtain it can cause unemployment and abort economic recovery. That won't do any good at all for any future generations.

I would stick with fiscal stimulus in the first couple of years ahead of us, even if it somewhat increases the deficits in the budget over those two years. At the same time, as I advocated before, I would make as much headway legislatively as possible to put into place deficit reduction measures to occur in, let's say, 1995 and 1996, and future years.

I want to explain the reasons for my views. For one thing, I don't think recovery is by any means in the bag, despite the news we have been getting. I think we have quite a long way to go before we restore full employment. There is little risk that a modest stimulus package will overheat the economy. There is minimal risk in the foreseeable future of any serious increases in the rate of inflation.

There are a number of reasons for worries that the expansion of demand, after the spurt of the last two quarters, will slow down. Some late 1992 incomes and spending, especially for consumption, were borrowed from 1993.

Twenty-four billion dollars in less withholding tax taken out of salaries and wages in 1992 means that there will be smaller tax refunds and higher tax liabilities in April 1993.

While that may have been foreseen by many people, its squeeze on liquidity could have some negative effects this year, the counterpart of any positive effects it had last year. Some reports say that bonuses and other incomes movable from one year to another were shifted forward in anticipation of higher marginal tax rates in 1993.

I think some other factors are more important. The prospect for United States exports are dubious because of the weakness of the economies of our principal major trading partners in Europe and the Far East. Ironically, we could also be harmed, at least for several quarters to come, by the belated effects of those countries to stimulate their economies.

As their central banks lower interest rates, they may cause our dollar to appreciate again. If we had our druthers, we would have those countries stimulate their economies by fiscal rather than by monetary policy.

Consumption spending has been running ahead of incomes in the latter part of 1992, especially ahead of wages and salaries. The fact that employment has lagged, as one of your charts showed dramatically, means that the incomes to support higher spending have not been generated by jobs. Without jobs or the expectations of jobs, demand could weakening.

One big question is how much room there is in the economy for expansion of gross domestic product before we get unemployment back down to 5. 5 percent or lower. I think the GDP gap that we have right now is—the gap that corresponds to an excess of around two points in the unemployment rate—is about 5 percent of GDP, or maybe even more. To eliminate a GDP gap of 5 percent in 1996 would mean that annual growth during the next four years would have to be, on average, 1.25 percentage points higher than the normal sustainable growth rates—one-and-a-quarter being one quarter of five. The sustainable growth rate is the growth rate that you can sustain, with a more or less constant rate of capacity utilization and of unemployment, by the normal growth of labor force and of productivity. That rate is what I would think is around 2. 5 percent. Adding the two and a half, which is that estimate of the normal growth rate, and the one and a quarter needed to make up the gap, means we need a 3.75 percent average annual growth rate during the coming four years.

In contrast, the blue-chip consensus forecast for 1993 is much lower than that, 3. 1 percent. I submitted some charts that bear on this, on these points.

In my package, Figure 1 shows how much the growth in GDP has lagged behind in this so-called recovery since the trough in March 1991. It has lagged behind normal growth in a recovery, the average over the seven previous recoveries. That is very much like the chart that Bob Solow used in Little Rock and a similar JEC chart.

The next one in my packet is one of your own. It shows the dramatic lag in job creation during this recovery compared to the previous ones.

The third figure in my little package—actually labeled Figure 2—shows GNP, because it starts back before GDP was available, real GNP in dollars. "Potential" real GNP is estimated as a smooth trend. A break in that trend is put in at 1973, with 3. 5 percent growth before and 2.5 percent after. The wiggly cyclical path is that of actual real GNP, which is usually below potential and sometimes above.

The times above were the overheated years of Korea and Vietnam, where unemployment was probably unsustainably low. Potential, as I estimated it, happens to correspond to 4 percent unemployment in the pre-1973 earlier period and to a higher rate, 5 percent or a little more, in the later period.

The next chart, titled Figure 3, shows the GNP gap, which comes from the previous figure. In Figure 3, it is compared with the unemployment rate. They move together qualitatively quite well, and turn pretty much at the same times. However, the amplitude of the GNP gap is much greater, about two-and-a-half times greater, than the amplitude of the unemployment rate. The implication is that to improve the unemployment rate by 2 percentage points in four years would require a 5 percent increase in GDP, on top of normal sustainable growth.

This relationship is often known as Okun's law, after the late Arthur Okun who was the Chairman of the Council of Economic Advisers in the Johnson Administration. When Bob Solow and I went to Washington with Kennedy in 1961, Art Okun joined the staff and did the work that led to this analysis.

It will take about nine million jobs from 1992 to 1996 to achieve this recovery in GNP, or GDP. That includes re-employing many workers now unemployed, many currently discouraged workers now who are not even counted as unemployed, and also taking care of the normal growth of the labor force, around 1¼ million a year, or five million for the four years.

In Figures 4 and 5, I am trying to show how this recovery differs from previous business cycles, how labor markets are weaker than they appear to be if judged by the unemployment rate alone.

First, as we all know, much of current unemployment comes from permanent job losses rather than from reversible layoffs. An unusually large group will never be re-employed in the same jobs or by the same employers. In Figure 4, the title "Layoff and Total Unemployment Rate" should read "Permanent Layoff and Total Unemployment Rates." The permanent layoff/unemployment rate is a much higher number now, especially relative to the total unemployment rate, than in previous periods.

The last figure repeats those two unemployment rates—the permanent one and the usual one—and compares them to a job vacancy index. The vacancy index is a ratio of the help wanted index to an employment index, normalized so it can be put on the same chart as the two unemployment rates.

The point is that the vacancy index is a lot lower than one might have expected it to be at the rates of overall unemployment that we are seeing. The jobs just aren't out there. New demand that will translate into new and replacement jobs is more problematic than it has usually been in recoveries. It may take, in many cases, an investment in different industries and in different locations to provide those jobs.

The second question in your letter of invitation concerned productivity. We have had some good news lately about productivity. It is good in the sense that it may signal some permanent increases in productivity and in the rate of growth of productivity, not just the usual cyclical phenomenon. The usual cyclical phenomenon is that apparent productivity rises early in business cycle recoveries because there are overhead workers on payrolls and redundant production workers on payrolls who can begin to produce once sales revive.

There are probably not so many of those surplus employed workers now. There has been plenty of time and incentive to shed those workers over the past three years, and we read daily about companies doing so. The workers are still there, not necessarily unemployed, but out of the labor force temporarily.

Some of the productivity gains that we have recently observed in 1992 and 1991 are probably good signs for the future growth. But they will only be beneficial to the economy if we actually use them by employing the displaced workers, instead of wasting them in higher unemployment for long periods of time. So there may be more room for expansion of GDP than the calculations that I reported above suggest.

Thank you very much.

[The prepared statement of Mr. Tobin starts on p.102 of Submissions for the Record:]

Representative Obey. Mr. Solow, please begin.

STATEMENT OF ROBERT SOLOW, PROFESSOR OF ECONOMICS, DEPARTMENT OF ECONOMICS, MASSACHUSETTS INSTITUTE OF TECHNOLOGY; AND NOBEL LAUREATE IN ECONOMICS

Mr. Solow. Thank you. It is a real pleasure to help start off this year's series of Joint Economic Committee hearings, and I want to thank the Committee for the opportunity, and I am not just being polite when I say that.

Many people, not just a few economists, hope that the way is now open to cautious and thoughtful activism in economic policy. And it is a privilege to be asked to make a contribution to that process.

We live in the short run, and I am sure that most of your discussions in these hearings will be about the immediate prospects for our economy, about the size and shape of the appropriate fiscal stimulus, if there should be a fiscal stimulus, and about the deficit that came to dinner.

We can get to those questions in due course this morning, but I want to begin by taking a slightly more long-run point of view and focus on the linked issues of jobs and productivity, as Jim Tobin did. I hope in this way to avoid the danger that is always present in discussions of any kind of policy, that we redouble our efforts as we lose sight of the goal.

You will remember that during the 1980s—at least after the deep recession of 1981 and 1982, which showed up on your charts, Mr. Chairman—the U.S. economy was, in one important respect, the envy of Europe and much of the world. Between 1982 and 1990, we generated 20 million payroll jobs in the country. We even had the luxury of worrying that about 19 million of those 20 million jobs were in service-producing industries.

During that same period, the advanced economies of Europe experienced only trivial increases in employment. Our euphoria about this contrast was tempered by the observation that has again come up in your discussion, Mr. Chairman, and in Jim Tobin's, that U.S. productivity, output per hour worked in nonfarm business, rose by only 8 percent during that same long upswing. Those two facts are connected by a piece of nonpartisan arithmetic.

The rate of growth of employment and the rate of growth of productivity add up to the rate of growth of output. Given the path of productivity, we could have had faster or slower growth of employment if we had managed faster or slower growth of output.

It is natural in a discussion like that to think the productivity growth rate was the given in the short run, although that is not quite true. That, too, came up in Jim Tobin's remarks. We may now be seeing some of the dark side of that earlier success in job growth.

Everyone is painfully aware that payroll employment today is still lower than it was in 1990. Despite all the favorable straws in the wind in recent months, the country has not yet managed a monthly increase in employment large enough to cut into open and hidden unemployment. Even more ominous is the continual stream of announcements of major layoffs at flagship corporations like IBM, General Motors, United Technologies, Sears, and still others.

In this context, it doesn't sound like good news that nonfarm business productivity is up 4 percent in the past two years. Given that pace of productivity growth, it would take a considerably faster increase in output to generate a decent number of jobs. It almost looks as if all that job growth in the 1980s may have been too careless to last. Businesses, including some of those large businesses, may have added workers that they did not really need and the competitive pressure to cut costs and eliminate uneconomic capacity is now working in the opposite direction.

Any increase in productivity is a good thing when looked at from the cost side. The labor shedding that we are seeing now, the squeezing out of workers who are associated with capacity that can't earn its way or who are not really needed for the efficient operating of viable capacity, even that kind of labor shedding is necessary and, in its way, useful. At least it tells us that we have labor resources to use elsewhere in the economy if we can generate the demand for the goods and services that they might produce if they were employed.

But labor shedding is a lot less promising for the long run than the productivity gains that come from the appearance of new capital and new technology, and from productivity gains that themselves represent additions to state-of-the-art capacity to produce. We would be better off in every run if we were experiencing more of that kind of productivity increase.

Those questions are central to an evaluation of the current state of our economy and the room it offers for expansionary fiscal and monetary policy, and I think those questions are part of the thought behind thoughtful activism. We know that our economy is not using all of its capacity to produce, and not employing enough of its available labor. The Federal Reserve's index of capacity utilization in industry stands at about 79 percent, while it was above 84 percent in the first half of 1989.

To frame an overall policy, we need a notion of how much higher real GDP could be this year and next without pushing up against the barriers that could revive inflation.

Suppose we take 1988 as a reasonable benchmark, when the civilian unemployment rate was 5. 5 percent. How fast has potential GDP been growing in the last five years? I am referring now to one of Jim Tobin's diagrams. The fact is that experts differ on the speed of the trend of potential GDP. Two percent a year is on the low side of most of the expert's estimates and 2. 5 percent a year is on the high side. Most of the model builders would settle for something in between. If we proceed that way, the arithmetic suggests that the current gap is about 4 percent of GDP, that is a little more conservative than Jim's 5 percent figure. Even 4 percent would mean that we are about $250 billion short of our potential production.

The history that I was sketching a minute ago suggests that there may be a little extra uncertainty in these estimates, and the cushion may perhaps be a trifle bigger than it looks, which would get me closer to Jim's ball park.

Now, what about the immediate future? How fast will potential GDP rise in the year ahead? A pessimist would stick with 2 percent, an optimist might be at or a tad below 2. 5 percent. I will opt for 2. 25 percent, recognizing that all this smacks of more accuracy than anyone can hope for. If actual GDP rose by 2. 25 percent during the four quarters of 1993, the gap between actual and potential will still be 4 percent early in 1994 and the unemployment rate would remain near 7. 1 percent. It would take faster growth in GDP to narrow the gap and reduce unemployment. Every increment of 1 percent in the 1993 growth rate eats up 1 percentage point of the initial gap and reduces the unemployment rate by four- or five-tenths of a point. That is Okun's law that Jim was describing. The best mainstream forecasters now expect real GDP growth of 3. 2, 3. 4 percent in 1993. That is a little higher than the blue-chip average.

Most of them are busy, as we speak, shading those forecasts upward because the recent bits of news have been pretty good, although not overwhelming. It is important to realize that those forecasts already presuppose a small stimulus package early this year, generally in the range of $15 to $20 billion. If that story were to come true, you would be back here a year from now looking at a GDP gap of almost 3 percent and an unemployment rate near 6. 5 percent.

I suppose you could say that things were getting better, but as an experienced grader of examinations, I will award only a gentleman's "C" to that kind of performance.

There is enough slack in the economy to warrant a more aggressive approach. The payoff would be higher output, more jobs, with little danger that inflationary pressure would return. It seems to me that 4-plus-percent GDP growth in 1993 is a fairly conservative target for policy. That would require a stimulus package near $35 billion and an accommodating monetary policy beside.

In that scenario, a year from now the gap between performance and potential would be cut nearly in half, perhaps 2 percent, and the unemployment rate would probably be nearer 6 percent rather than 6. 5 percent.

I emphasize that this is a reasonably cautious approach. It would leave some slack in the economy and give us something to think about for 1994. There would be more room for the unemployment rate to come down. Of course, having said that, I am an expansionist at heart. If the choice were really mine, I would probably go for a bit more than I have recommended so far. I don't really believe that an economic expansion is like a Popsicle, in the sense that the slower you lick it, the longer it lasts. I think that there may be more slack than the standard figures allow, but I am putting aside my natural youthful aggressiveness and trying to be mature.

If I can take a minute or two more, I would like to say something about the composition of a stimulus package. The general principle is that we should be trying to favor investment at every turn, at the expense of consumption. An investment tax credit for equipment should definitely figure in a package and so should a permanent R&D tax credit. We add effectiveness to a investment tax credit if it were temporary, or at least had its rate tapering from a higher temporary rate to a lower permanent rate.

I would vote for some productive infrastructure, but would not go hog wild on what is rapidly becoming a buzz word. The goal should be to do those things that enhance the productivity of private production. Most of those things will involve maintenance, repair and the proper pricing of congested facilities. Monuments are part of the problem, not part of the solution. My hopes for faster growth of potential ride primarily on industrial equipment, industrial R&D and a larger and more skilled labor force. Expenditures on those items are almost sure to do good.

Timing is everything. The most effective time for stimulus is soon. The sooner the economy picks up momentum and gets closer to capacity, the sooner we return to reducing the budget deficit and provide domestic saving for what we all hope will be a permanently higher rate of investment.

I want to make only two general points about the deficit reduction phase of current policy. The first point is that the credibility of the program is far more important than another $10 billion added to or subtracted from the target deficit four or five years down the road. The deficit reduction part of the program should be definite, detailed, concrete and specific about the taxes to be increased and the expenditures to be cut, and when. It is hopeless if you are seen as people saying, yes, dear.

The second point follows from the first. Once the Congress and the Administration commit themselves to a path of deficit reduction, you will have surrendered your ability to respond to macroeconomic surprises by making short-run adjustments to macroeconomic policy. You will have lashed yourselves to the mast like Ulysses and the Sirens, and for much the same reason.

Macroeconomic stabilization would then be in the hands of the Federal Reserve. You should make damn sure that the Federal Reserve understands and accepts its responsibilities for the economy. Treasury debt management can help, as it can and should help now, by shortening the average maturity of the debt, but the Fed would be the main player once you have committed yourselves to deficit reduction.

[The prepared statement of Mr. Solow starts on p.110 of Submissions for the Record:]

Representative Obey. Thank you.

Mr. Meltzer, please proceed.

STATEMENT OF ALLAN MELTZER, PROFESSOR OF POLITICAL ECONOMY AND PUBLIC POLICY, CARNEGIE MELLON UNIVERSITY

Mr. Meltzer. Thank you, Mr. Chairman. It is a pleasure to appear again before this Committee and contribute in a small way toward the important societal choices that have to be made or will be made in the next few months. The year 1993 has started out as an unusual year. The new Administration hit the ground backpedaling. Senators Sarbanes and Sasser have become avid monetarists, interested in all of the movements of M-2 growth, and I have emerged as a defender of the Federal Reserve.

The economy continues to expand as we enter 1993. Your letter describes the recovery as anemic. I would not use that term to describe recent performance. Preliminary data for the second half of last year show a growth rate of

3.75 percent, well above average growth for the U. S. economy and much better than the average for the previous three years.

For 1992, as a whole, growth was slightly above the historical average of 2.8 percent, with only one quarter below the average rate. This performance hardly justifies the mountains of paper that have been used to describe the economy as stagnating or anemic, or to forecast second and third "dips" that, we now know, did not occur.

Of course, the economy must grow at above average rates during recoveries to compensate for falling output during recessions, so we should not be complacent about the recent record, but we should avoid additional short-term stimulus based on faulty interpretations. Policy in 1993 should concentrate on encouraging sustained growth and productivity in order to continue the very promising improvement in productivity achieved during this recovery to the present time.

There are at least four reasons why the recovery has been slower than the postwar average. First, many of the earlier, more rapid cyclical expansions laid the seeds of future inflation followed by disinflation and recession. The main reason: excessive money growth in the early quarters of recovery later spilled over into inflation.

Second, mild recessions are typically followed by slow recovery. Despite many fanciful allusions to the Great Depression, the 1991 recession was one of the postwar era's mildest; hence, the recovery should have been expected to be and has been mild.

Third, the recovery has labored against sizable defense cutbacks. It has not been possible to beat swords, tanks and airplanes into plowshares or machine tools without making sparks. The worst performance in this recovery is concentrated in California and in the Northeast where defense industries and electronics have reduced employment much faster than peacetime jobs have been created.

Fourth, falling real estate prices have been a problem for banks from Australia and Japan to Britain and the United States. The Fed met this challenge with moderate monetary expansion that lowered interest rates, but did not reflate real estate prices. Lower interest rates improved banks' profitability, probably sparing us the cost of a bank bailout, and let many property owners refinance with lower carrying costs.

Avoiding reflation preserved the benefits of lower inflation and encouraged the cuts in long-term interest rates that are essential to the transition to lower inflation. These reductions in long-term rates have continued in 1993. There are costs to a slow recovery but, so far, the costs have been small and there are some offsetting benefits.

The long-term benefit of a cutback in defense spending is the resources released for private use.

It is too soon to know whether slow growth of consumer spending during this recovery indicates transition to a higher average saving rate or is a temporary change. Slow inflation has many benefits. The rate of wage increase is now aligned with productivity growth. Unit labor costs for U. S. industry have fallen relative to foreign competition so that exports have continued to grow at an 8 percent rate despite recessions in many overseas economies.

Lower inflation reduces the tax on durable capital that results from the failure to index depreciation allowances. If low inflation is sustained, it will be a lasting benefit for capital intensive industries. It is beyond logic to suggest that the government should offer firms an investment tax credit while raising the hidden tax on capital by increasing future inflation.

The best available evidence suggests that long-term growth is not changed by the slow pace of recovery. The difference between the recent 2.75 or 3.75 percent over the last six months and a more rapid 4 percent or 5 percent recovery will be made up in future years. A durable recovery and prolonged expansion is important for making up the substantial difference.

Future income is not equivalent to current income of course, so there is a cost of slow recovery; but the cost is only a small fraction of the difference between 2.75 percent and 4 percent growth for a year or two, and if inflation continues to decline the loss will be compensated, in whole or in part, by the benefits of lower inflation. And low inflation will extend to years of expansion.

Some critics of the Fed and some members of this Committee have been critical of the slow growth of a particular broad measure of money known as M-2. In the past M-2 growth has been a reliable indicator of long-term growth of nominal GDP. There is no reason to believe this long-term relationship has changed. However, the short-term relationship between the growth of M-2 and the growth of nominal GNP has always been subject to relatively large departure from a long-term relation.

Forecasts of near-term spending, based on M-2, have often been subject to relatively large errors. The same is true of the more complex interactions in large scale computer models containing hundreds of equations. Indeed, all short-term economic relations are subject to large errors.

Few forecasters predicted the jump in GDP growth in the second half of last year. Until November, some were still revising downward their forecasts and predicting a return to recession in the fourth quarter. It would be a mistake to give credence to the cacophony from these croaking Cassandras.

We should choose policies that promote sustained growth with low inflation, not short-term recovery at the expense of future growth.

Other measures of money do not show the same pattern as M-2. Money issued by the Federal Reserve is called the monetary base. The monetary base consists of the reserves that bank holds and the currency that we all use. Every stimulative action to increase money and credit increases the amount of monetary base outstanding. And when the Federal Reserve reduces the monetary base, measures of money and credit fall.

The base and all measures of money include holdings of U. S. currency by foreigners. Much of this currency is held outside the United States. It is not used for domestic spending and it does not affect U. S. GDP.

A chart in my prepared statement shows the relation between the growth rate of spending, GDP, and the growth of domestic monetary base—the monetary base net of estimated holdings of U. S. currency. These estimates were prepared by researchers at the Federal Reserve Board.

The chart compares the growth of spending at annual rates in a given quarter to the annual growth of the domestic base for the period ending six quarters earlier. That is, there is a six quarter lead of base money before the turning points in GDP.

As you will see from looking at the chart, it shows that all of the recent turning points in money growth with a six quarter lead have predicted the turning points in GDP growth after the 6 quarters have elapsed. This correspondence is close for the period since 1985 and suggests that monetary growth has been important over this period in producing the recovery that began in 1991.

Like all such relations, this one is subject to change. If the relation holds, growth of the domestic pace predicts the growth of spending in 1993. I read the chart as saying that contrary to the current critics, the Fed eased money throughout the current recovery. There is now substantial monetary stimulus.

The message for the future is the continued growth of the domestic base at recent rates will be adequate to sustain recovery and will raise inflation perhaps by 1994. Now is the time to stabilize the economy and prevent that increase. Prudence calls for about 2 percent less growth of the domestic monetary base than the average of the last two years. This would lock in the gains against inflation brought about by the tight monetary policy from 1989 to 1991 and contribute to a durable expansion with low inflation. It would avoid repeating the counterproductive policies of the 1970s that led us from boom to inflation to bust.

Productivity growth in 1992, 3 percent from fourth quarter 1991 to fourth quarter 1992 was the largest increase in 20 years. That takes us back to 1973 when your charts show that productivity entered its period of slow growth. In manufacturing, reported productivity growth has shown improvement for almost a decade, but service-sector productivity has not.

Recent estimates suggest that after falling through the 1970s and the 1980s, service-sector productivity has shown a sustained increase since early 1990. Service-sector output per private service job—a broad measure of service-sector productivity—reached a peak in 1976, declined until first quarter of 1990, and has now advanced 5¼ percent from that base to recover in 2¾ years, almost the entire decline of the previous 13 years.

The recovery of service-sector productivity growth is very welcome. Productivity growth is the necessary condition for sustained growth of real incomes and living standards.

Productivity growth not only raises standards of living, but the historical record suggested to Simon Kuznets earlier, as it has to me recently, that over long periods economic growth narrows the spread of the income distribution about which you commented. Everyone gains from growth, but low-income earners gain relatively more, so income differences narrow slowly but steadily.

The opposite side of the increased productivity growth is the slow growth of employment during the recovery to date. When combined with a loss of jobs in the defense and defense related industries, we get below average growth in employment and the highest unemployment rates concentrated in those states with largest defense-related activities.

For 1992, the average unemployment in the ten states with heaviest concentration of defense spending was considerably higher, more than a few percentage points higher than unemployment in the other 40 States.

Much current discussion suggests that the most urgent necessity is to reduce the deficit while increasing spending to provide short-term stimulus. I do not share that view. The recovery will continue without additional short-term stimulus. The reported deficit is poorly measured and overstated. The budget deficit is not as much of a problem as is widely repeated.

More important and deserving of more attention is how the money is spent, how resources are used, and how the deficit is financed. If we, as a nation, had incurred the same deficits but used all the borrowed money for productive investment in human and physical capital, we would be much richer and would have higher living standards. The economy would generate revenues sufficient to reduce debt in the future.

Public policy has discouraged investment in several ways. Depreciation is not indexed so inflation is a tax on invested capital, particularly long-lived durable capital. The 1986 Tax Act shifted taxes from consumers to owners of capital. Earned income including saving is taxed, and is almost certain to be taxed at higher rates beginning this year.

Taxing saving is not a way to encourage growth and raise living standards. Taxes should be shifted from earned income to consumed income. This could be done most readily by allowing taxpayers to subtract their annual saving from adjusted gross income and levying the tax on the remainder–spending or consumed income. This change would increase saving. Corporations should be allowed to write off all or most of their purchases of machinery and equipment. This would increase productive investment and productivity.

Encourage general research and development and improvements in the quality of education and training by promoting competition in schooling and by increasing incentives for learning. In many countries, school grades and performance are important for getting a first job. This encourages effort and learning. This is not true in the United States.

I am told that one reason is that our laws would treat such information as evidence of discriminatory action on the part of employers.

Avoid the drift into protectionist policies and reverse the quotas and so-called voluntary restraints that burden consumers, lower living standards, reduce competition and threaten the world trading system.

The United States has led the world through nearly 50 years of growth. The most-favored-nation principle that started in the U. S. Congress, and multilateral tariff reduction led by the United States, were major forces producing this achievement.

Now, many in this same Congress want to turn back toward protectionist policies that are costly to us and destructive of the rules of open trade. They urge policies that are inimical to growth and that lower living standards here and else where.

Much of the U.S. economy is in a strong competitive position. Unit labor costs in many industries have fallen far below comparable costs abroad. This is the time to benefit our own economy by adopting rules for freer and more open trade and by strengthening enforcement through GATT.

Lower payroll taxes would encourage employment. A higher minimum wage and more mandated benefits raise the cost of employing labor and reduce employment.

Avoid the temptation to develop an industrial policy. The private sector is not always right, and the public sector is not always wrong. What matters is the batting average over years or decades. Be happy that you did not subsidize investment in the supersonic transport, HDTV, the fifth generation computer, and many other well-advertised projects that were at one time or another claimed to be critical for our prosperity or even our survival.

Beware of the Marxist fallacy pushed by proponents of protectionist policies and industrial policy that progress is limited to the so-called leading sectors. That isn't true.

The policies I urge on you are policies for growth and higher living standards, not short-term stimulus. If you remove barriers to trade, avoid costly and burdensome regulation of commerce and industry, encourage improvements in the quality of education for all, reduce taxes on saving and investment and insist that the Federal Reserve maintain the near price stability that is now ours, growth and living standards will continue to rise as they have throughout our history and jobs will increase and continue to expand, as they always have.

Thank you.

[The prepared statement of Mr. Meltzer starts on p.113 of Submissions for the Record:]

Representative Obey. Thank you very much.

Let me start by observing that after I watched President Clinton's town meeting last night, I then had the great pleasure to watch Congressman Newt Gingrich respond to the President. And that noted Nobel Laureate, Mr. Gingrich, indicated that, in his view, we were going to have a recession sometime in the next two years. And he indicated that we had to remember that we were going to be losing several hundred thousand jobs because of continued builddown of the defense budget, and he also indicated that we had over 300,000 jobs or we had already had, announced by companies, future plans to lay off 300,000 people.

Given that caution by Mr. Gingrich, I guess I am a little surprised that the Republican Party line appears to be that we should not buy a little insurance by providing the kind of stimulus package that Mr. Solow and Mr. Tobin are urging this morning.

I want to pick up, Mr. Tobin, on something that you said when you talked about the difference between layoffs in previous recessions and this recession. This chart, I think, emphasizes again the point that you made earlier. What this chart demonstrates is that if you take a look at past recessions of 1975, 1981-82—you see that represented by the gray—we had significant increases in temporary layoffs. A large peak here, a large peak here; those accompanied large increases in permanent separation. But if you take a look at what has happened the last year-and-a-half, from this point on the chart, you see that, in fact, from 1983 on, temporary layoffs remained fairly stable.

But you have had a large amount of those layoffs being permanent and, in fact, since 1990 we have had a very much larger share of the layoffs being permanent layoffs. And that seems to me to bear out your contention that we need to recognize that in some ways, including that one, this unemployment is more severe than the raw numbers would indicate. It would also indicate to me that we have not had such a high share of the unemployment, which was represented by permanent layoffs except in the most serious recessions, which we have had in the postwar period.

Let me ask a couple of questions, and ask Senator Sarbanes for his comments and questions.

I think one of the jobs we are going to have as we proceed down the road that you are talking about with a modest stimulus package, we are going to have to explain to the public in very clear terms why it is that in the middle of an effort to reduce the deficit, long term, we are still trying to do something which might appear on the surface to be contradictory by also providing a short-term stimulus package.

Tell me, if you would, what we ought to tell our constituents when they ask us whether that is not, in fact, inconsistent, Mr. Tobin and Mr. Solow, since you are the two prescribing that medicine.

MR. TOBIN. I think what the proper medicine is for the patient depends on the circumstances of the patient and what the disease is. So it is not appropriate to give this economy a dose of deficit reduction medicine, which is going to reduce demand for goods and services and the jobs related to those demands, at a time when the economy is weak and barely coming out of this long period of stagnation since the so-called "trough" in 1991 first quarter.

When the economy is robust, when we have got unemployment and excess capacity back down to normal peacetime prosperity rates, then the economy can absorb deficit reduction. In those circumstances, it will still be necessary for the Federal Reserve to make the adjustments of monetary policy that make up for the restriction of demand by fiscal policy.

I admit that this is a subtle point and hard to get across to reporters, pundits, columnists and talking heads. Maybe it is sometimes hard to get across to Congress and even to our students. But the problems are there, so we have to do our best to explain them.

REPRESENTATIVE OBEY. Mr. Solow?

MR. SOLOW. I am tempted to adopt a medical analogy, which probably explains why medical costs are so high. I am of an age where a certain number of my friends are having surgery every year and it is not unknown for them to have to be built up to a degree of health where they can withstand surgery.

Deficit reduction will be contractionary for the economy. That is why the Fed is needed to take up some of that slack. It would be a terrible mistake, I think, to impose that necessary contractionary force at a time when the economy is just struggling to emerge from what has not been a very deep recession, but has not been a typical recession either. It has lasted a long time. Natural recovery from it is slow.

We are looking at a chart that suggests the private economy is finding it very difficult to generate permanent jobs. The important thing is to commit the patient to that surgery and then to build him or her up to health where the surgery can be withstood.

MR. MELTZER. May I point out that the same arguments, if you accept them, which apply to spending increases must apply just as logically to tax rate increases. If you accept the argument, you should not be in favor of the President's program to increase tax rates on corporations, if that is what comes about, and tax rates on individuals in order to cut the deficit. They would be counterstimulus measures also.

REPRESENTATIVE OBEY. I would grant that, but I think that we should not assume timing with respect to the President's tax suggestions. So far as I know, the President is not proposing any significant tax increases which would go into effect immediately, which I will grant would have a contractionary effect on the economy.

It seems to me, gentlemen, what you are saying is that unless we build up enough momentum in the economy first, efforts to achieve deficit reduction might in fact not succeed. We might in fact run into a situation such as we did in 1980 when efforts were made to cut the deficit, but because of the economy sag the deficit in fact grew larger no matter what the political pronouncements of people in the White House encompassed about their intention of cutting the deficit.

MR. SOLOW. You would be in danger of giving Mr. Gingrich the recession he is hoping for.

REPRESENTATIVE OBEY. Let me ask, Mr. Meltzer, I would like you to expand on your comments in your statement, and let me quote exactly so that I don't misstate what you said:

> The reported deficit is poorly measured and overstated. The budget deficit is not as much of a problem as is widely repeated.

Would you elaborate on that, please?

MR. MELTZER. First, as far as measurement, there are lots of problems about how deficits get measured. The current measures of the deficit include things like the costs of the S&L bailout. These costs have no economic burden at all. The burdens incurred were incurred when resources were used badly or wasted back in the 1980s, or earlier. When the deficit was increased by transferring these expenditures onto the deficit, losses which had been on the books of various thrift agencies, the savings and loans, were replaced by bonds, and this became part of the measured deficit. So that part is not an important part.

The interest payments on the deficit are rather neutral in their economic effects, and a good part of the deficit is made up of interest payments. For those reasons, many economists concentrate on what is known as the "primary deficit"— that is, the deficit net of S&Ls.

Those are some of the reasons why I say this measure does not adequately represent what it purports to measure. There are a lot of other reasons that would occupy more time and perhaps try your patience more than is necessary.

Second, what is important is how we use resources. What gets crowded out in most discussions of the deficit is how we use the resources. If we had borrowed that money and invested it productively in human or physical capital, we would be receiving returns.

Our problem as a nation is to shift some of our resources away from spending for consumption and onto spending for investment, both public and private, particularly in areas like education and development of physical capital. With the same deficit, short term, and greater investment at the expense of consumption and more savings, the economy would grow faster, produce more, earn better, and have some resources available to retire the deficit in the future.

REPRESENTATIVE OBEY. Well, it sounds to me as though that, at least in part, reinforces something which was in Mr. Tobin's statement, indicating that there is a very different economic result in the kind of deficits which were incurred in the 1980s when those deficits were used to finance a large run-up of military expenditures and tax reductions, which were not necessarily put into productive enterprises, versus the kind of investments which the President has been talking about by way of stimulating business capital investment and by way of increasing education, training and infrastructure efforts.

MR. MELTZER. The use of resources is very important. I would add that the money that was spent on the defense buildup in the 1980s is now, of course, permitting us the opportunity to reduce the military spending in the 1990s. That is a good part——

Representative Obey. I don't want to get into a debate about whether it was a good idea to raise defense spending. I am trying to make the point that that was not the most economically productive way that you could have—

Mr. Meltzer. Yes. I am trying to be agreeable.

Mr. Tobin. I agree with what Allan said and what you said. It is important, though, if you make a shift away from consumption into higher saving, say in 1995, when we have an economy that is robust enough to stand higher taxation, to make sure that the monetary policy is going to cooperate, that interest rates will be low enough so that the resources released from collective or personal consumption are in fact channeled into productive investment and not wasted in unemployment and excess capacity. That is very important. It is not something that happens automatically, in my opinion. It is something that requires a cooperative monetary policy.

In line with what you were just saying, deficits for public facilities, for public investment, for education, which will increase productivity and real wages in the long run, should not be regarded the same as deficits for consumption. I hope the President will not be apologetic about deficits that are run for the good purposes that he advocated so strongly during his campaign.

Representative Obey. Thank you. Let me just ask one more question on the deficit. I have an instinct on this; I suppose it is a bias, but I would like to know whether you share it or not.

Right now, my instinct is that most people in the press, when they talk about the deficit, have a picture in their mind of this chart showing that the nominal dollar level of that deficit has exploded since 1980, and they want to see this come down, or at least it is easier for them to understand what is happening if you talk about the deficit in terms of reducing it by specific dollar amounts. The problem with that is that, as this chart indicates, during the 1981-84 period, while the country was promised that the deficit would perform in a very exact fashion, as represented by the green bars—this was supposed to be the path by which the deficit got down to zero if we listened to the Reagan plan—because even presidents cannot command the economy to do specific things; they don't have that power—the deficits in fact rose by very large amounts during that period.

That leads me to this conclusion. I wonder if you would comment on it. It seems to me that it is crucial, if we are to win public support for whatever the President proposes, that it have a serious long-term deficit reduction component, but that it be looked at in the right context. And it seems to me that this demonstrates the right context. The crucial issue is whether or not we can return to the trend line which we were following between 1946 and 1973, stalling out between 1973 and 1980, of reducing our debt as a percentage of our income over time in a very determined manner. If we can produce a package which will tip this line, which is now going up and is expected to go up even more rapidly, if we can begin to curve that line down again over a sustained 10-year period so that it is clearly, over the remainder of this century, resuming this downward path, that that is a much more important question than whether we hit $145 billion in deficit reduction the fourth year, $120 billion or $160 billion in that that is the way the President's efforts ought to be evaluated.

I would like your comments on that.

Mr. Solow. This is another one of those complicated questions, and I think that it is unwise to limit yourself to one way of describing the problem and the solution and the outcome of whatever is proposed.

It is certainly right that whenever you can scale debt and deficit magnitudes by the GDP, by the size of the economy, you will no doubt cause an extra eye or two to glaze over, but you will be giving a more accurate representation of what is going on. In describing what you expect to happen to the budget deficit in view of policies adopted, I think there is nothing for it but to talk in terms of the structural deficit as a fraction of GDP because that is what matters, and finding ways that sound simpler only obscures the issue.

I think, looking at what legislation is expected to do to the standardized or normalized, or high employment, or structural budget deficit as a fraction of GDP, is one line of argument. I think the picture that is now on the easel is another important line of argument, and I would not abandon that. I would caution you, though, that that curve responds very slowly to anything that you do now. So, again, you run the risk of exceeding the attention span of the listener by describing what is a complicated problem. And I would not give up. I would talk about that. I would talk about the deficit. I would just do it in the right way and in a logical way.

Representative Obey. One last question, and then I will ask Senator Sarbanes to comment.

You indicated, Mr. Solow, that you thought it would be far preferable and a far better economic effect if the investment tax credit, if it is proposed by the President, would be temporary. Would you elaborate on that?

Mr. Solow. Yes, sir. One can argue as to whether there is good social reason for having an investment tax credit permanently or not. What is beyond dispute, I think, is that any temporary part of an investment tax credit—whether all or only a fraction of it—exercises a very powerful incentive for businesses to shift investments through time. And an investment tax credit that goes away at the end of 1994 or on July 1, 1994, or something like that, will certainly attract a lot of investment into the interval between now and then, and it will subtract some of it from the interval after.

Well, the economy does not move regularly. Allan is more inclined than I am to forget about those short-run fluctuations. I think of them as mattering and mattering a lot. If it is desirable for the general health of the economy to fill in those troughs we talked about, then temporary tax reductions, tax reductions like an investment tax credit that give you a reward for something that you do now and then take the reward away, gradually or totally, sometime in the future, will certainly have a more powerful effect than one that doesn't have that aspect.

Mr. Meltzer. On the opposite side, your chart on productivity growth was very revealing of the longer term problems that were put up in other charts—why wages are not growing. Wages can't grow on a permanent basis unless productivity grows. But the economy needs permanently more investment in physical and human capital. The way to get that is to make these changes long term, to try to solve now, going into the 1990s and the next century, the long-term problems we have had for the last few years of not having high productivity growth. I see no great advantage in putting more investment into 1994 at the expense of 1995. That is not a direction that will solve the problem.

Put yourself in the position of a businessman in December 1994, who knows that credit is going to expire January l. He is going to put a lot of investment into December and November and October, but that is not going to do much to raise the average rate of investment in the economy over a long period of time. And that is what I believe the productivity chart, compensation chart, wage chart, and a lot of the others that you showed, including the distribution of income chart, I think those are things that you want to concentrate on.

MR. SOLOW. It is sometimes necessary to walk and chew gum at the same time. It is possible for a society to have two objectives. One may be a higher rate of investment in the long run. I think that is absolutely fundamental and important.

On the other hand, the economy does fluctuate in ways that are not productive, that cause numbers of people to be unemployed and cause businesses to lose profits. To the extent that it is possible to smooth those fluctuations, that won't do much for the longer term rate of growth, but it will smooth the fluctuations. It will not sacrifice long-term investment. I will go as far as anyone in trying to promote long-term investment. I see no reason to take the high and mighty view that as a tenured professor in a great university, I can afford to ignore two- and three-year fluctuations in output.

REPRESENTATIVE OBEY. Senator Sarbanes.

SENATOR SARBANES. Thank you very much, Mr. Chairman. I want to commend you for scheduling these hearings. I think they are very important, and I am pleased that I have the opportunity to participate in them here this morning and again this afternoon. I apologize for not being here to hear your opening statement. I have looked over your charts and can appreciate from them that it was a very strong outline of our situation.

Mr. Chairman, I do want to say one thing at the outset. I have been called a lot of things in my day—and I don't mind that—but I have never been called a monetarist before.

Mr. Meltzer, if you are going to call me names, I think you ought to wait until I get into the room before you start doing it.

I want to pick up on one last point that was made, and then I will lead into my line of questioning. I think the challenge–and Professor Solow picked up on it very well in response to Professor Meltzer–is to harmonize what we do in the short term with what we want to do in the long term. I think it is ludicrous to pretend that the short term won't impact on the long term. If the short-term downcycle is too great, it is going to have a lot of implications for what happens over the long term. It is going to impede our ability to swing into a long-term program.

I think President Clinton is very sensitive to that. He has been very emphatic in trying to make the point that what he wants to do is to address the short-term problems along the same track with what we need to do to address the long-term problems, to the extent that is possible. And I think it is possible to a large extent, and I think it is one of the challenges that is now before us.

I want to talk a little bit about the jobs recession that we are in, and I particularly want to get at the point of the extraordinary contrast between this recovery and previous postwar recoveries. I think it is absolutely essential to try to lay that out. Of course, what this chart shows, this line, is the growth, the average of the previous recession recoveries and jobs, the restoration of jobs coming out of the trough. (See chart below). This is what we are experiencing in this recession recovery cycle. It shows a dramatic contrast in recovering jobs in previous recessions. By this many months after the trough of the recession, we not only had recovered all the jobs that had been lost—here is where we were when we started down—but went well beyond that to recover many more jobs, to have some real job restoration.

In this recession, we are tailing along here. We have recovered maybe 30 percent of the jobs that have been lost. In the previous recoveries, we have ranged anywhere from 160 percent to 400 percent, depending on which recession you are talking about. But in all of them, at this point we have come back and picked up all the jobs.

We have not done that this time, and we continue to face a serious unemployment problem. Unemployment is higher now than it was at the trough, which was quite some time ago. We have never had an unemployment rate which, at this point after the trough, was higher than it was going into the trough.

The first question I want to put to you, it is my own view that the combination of fiscal and monetary policy in this recession recovery cycle has been far less stimulative than in any of the other previous postwar recessions. Would anyone disagree with that?

Mr. Meltzer. I would.

Senator Sarbanes. What is the basis of your disagreement?

Mr. Meltzer. If you look at my paper, you will see a chart showing changes in monetary growth measured as the growth of the domestic component of the monetary base compared to GDP. I have the chart here.

Senator Sarbanes. Is this the chart?

Mr. Meltzer. Yes.

Senator Sarbanes. That chart is trying to make your point that you think monetary policy has been more expansionary in this recession recovery period than a lot of us think.

Mr. Meltzer. Adequate expansion in this period; that is correct.

Senator Sarbanes. Has it been more expansionary than in previous recession recoveries?

Mr. Meltzer. It has avoided the problem of too much expansion.

Senator Sarbanes. That wasn't my question. Has there been more expansionary monetary policy than in previous postwar recession recoveries?

Mr. Meltzer. It has been as expansive as on the average of many postwar expansions.

Senator Sarbanes. How about fiscal policy? Has that been more expansive in this recession recovery period than in previous recessions and recoveries?

Mr. Meltzer. If you measure fiscal policy by the size of the deficit, it certainly has been highly expansive.

Senator Sarbanes. Is that how you measure——

Mr. Meltzer. That is one way in which people measure the size——

Senator Sarbanes. Is that how you measure it? That is how some members of the Congress measure it, many of whom don't understand the relationship between a deficit that results from a slow economy, as opposed to a deficit that is intended to avoid a slow economy, as opposed to a deficit that is intended to avoid it. Do you measure it that way?

MR. MELTZER. Not typically.

SENATOR SARBANES. Given that you don't, do you regard fiscal policy in this recession recovery period as more expansive than the previous recession recovery periods?

MR. MELTZER. Growth in government spending, which is a good measure of fiscal expansion, has been relatively strong, particularly in light of the cutbacks in defense spending.

MR. TOBIN. I think the proper way——

SENATOR SARBANES. Mr. Meltzer, I am having a lot of trouble with your answer. You throw this chart at me to make the point that you think monetary policy is more expansive currently than a lot of us think it is. Then, under questioning, you say, well, in comparison with previous recession recoveries, on monetary policy alone, it is as expansive.

MR. MELTZER. That is correct.

SENATOR SARBANES. And fiscal policy, I would assert, has been less expansive. So, if you take them in their totality, I think the stimulative impact of fiscal monetary policy combined in this recession, which is the way I put the question, has been less expansive.

Professor Tobin?

MR. TOBIN. I think the proper way to measure fiscal policy approximately is to look at the change in the noncyclical or structural deficit of the budget —not the absolute amount, but the change in it that has occurred because of acts of tax and expenditure legislation. The point is to eliminate the endogenous cyclical part—the changes that occur as a result of a response to the economic circumstances.

On that basis, it surely is true that there has been no fiscal policy stimulus in this particular business cycle. In that respect, it is almost unique. The much-touted 1980s recovery had the benefit the largest fiscal stimulus of any peacetime recovery in our history. I don't mean just in dollars but in structural changes of the deficit as a percentage of GNP.

That recovery was driven by a big fiscal expansion, so big that the Federal Reserve didn't have to do anything but decide how to let up on the monetary brakes, how much they could allow interest rates to come down. The Fed did not have to be extremely active. They didn't want deficit spending to overheat the economy, but they didn't want to offset it too severely either.

In this business cycle, I think it is misleading to look at the monetary plus fiscal stimulus in terms of the ordinary timing of business cycle peaks and troughs. Actually, if you measure relative to the potential GNP track, we were in a recession since the first quarter of 1989, and during all that time, as Allan's own graph shows, the monetary base growth was declining.

I don't particularly like to look at monetary policy in terms of M-zero any more than I like to look at it in terms of M-one or M-two or M-nine. But those measures confirm, I think, the conclusion I reach by looking at interest rates, that the Federal Reserve reacted very slowly, very late, and almost always too little. The Fed let the economy get out of their grasp. As a result, we need more fiscal policy to get out of this box than we would have if the Fed had acted more decisively and earlier.

SENATOR SARBANES. Professor Solow?

MR. SOLOW. I just want to add two brief points. I think Jim has covered the essentials.

On fiscal policy, it is certainly improper to look at federal spending net of defense spending and say, oh, well, if there hadn't been a reduction in defense spending, we would have a better looking fiscal policy. We sure would. But we did have a reduction in defense spending, and a sensible fiscal policy would have replaced that by some other fiscal stimulus.

The second thing I would like to point out——

SENATOR SARBANES. It is reminiscent of the 1980s when we ran defense spending way up, and everyone said government spending is not going up. It was as though defense was something separate and apart from government spending.

MR. SOLOW. The second point I would like to make, Senator, is that, as a relatively recent monetarist, you are perhaps not fully acquainted with all the twists and turns of monetarists' doctrine, but there are other longer term——

SENATOR SARBANES. I don't want to get in that box because I don't want to have to try to become acquainted with the twists and turns. I am anxious to stay out of that box.

MR. MELTZER. May I add——

SENATOR SARBANES. We are going to let Professor Solow finish. Then we are going to come to you. Obviously, you want a chance to respond. We will give it to you in just a moment.

MR. SOLOW. I am about as much of a monetarist as you are, Senator Sarbanes, but there are respectable people with a long, respectable history of monetarism, Milton Friedman and David Fand, who concluded from their own interpretation of the entrails that in fact the Federal Reserve did not offer any genuine support for the economy, but followed the economy down passively.

MR. MELTZER. Senator, let me just give you the figures. It is called into question about federal nondefense expenditures. Let me give you the figures from the National Income Account Budget. Between the third quarter of 1990 and the third quarter of 1991, National Income Account total expenditures increased by $83 billion. Between 1990, the third quarter of 1991, third quarter of 1992, which is the last figure I have here, it increased by $111 billion.

SENATOR SARBANES. Does not include unemployment insurance?

MR. MELTZER. It includes all expenditures which appear on the National Income Account.

SENATOR SARBANES. I want to be clear. Would unemployment——

MR. MELTZER. Yes, it includes unemployment.

SENATOR SARBANES. An increase in unemployment insurance, as a consequence of the slow economy, would be reflected in those figures you are giving me; is that correct?

MR. MELTZER. That is correct. We could take the cyclically adjusted budget deficit—unfortunately, they are not available for the whole period—but that also has been rising for the period of the recession itself. The last figure I have here is through the second quarter of 1991. That number was also rising.

For example, it rose by approximately $26 billion from second quarter of 1990 to second quarter of 1991, but the unemployment surely doesn't make up for the bulk of the $111 billion of increase in National Account spending. That is 8 percent of the budget. That is, it is an 8 percent growth rate of the base budget, so that is a relatively expansive fiscal policy, as I would measure fiscal policy, looking at the growth of total expenditure.

Offsetting that, of course, is what is happening to receipts on the National Account budget, but those receipts over the same period, when we had an $111 billion increase in expenditure, increased by $28 billion. So the net of that was an expansive federal program. How it compares to other periods I don't happen to carry in my head.

Senator Sarbanes. Less relevant to the question that I put out.

Mr. Meltzer. Yes, it is.

Senator Sarbanes. Now, Milton Friedman said on October 23 in the *Wall Street Journal*:

> The Fed's inflation objective is close to being achieved. Indeed, the Fed is temporarily overshocked. Continuation of M-2 growth at 2 percent per year would imply actual deflation, not negligible inflation. Given its departure from its own policy, the Fed now needs to speed up sharply monetary growth to bring M-2 back to its target range and then hold it there.

I take it you disagree with that, Professor Meltzer?

Mr. Meltzer. And the facts have not borne that out, of course. Let me say, Senator, that we complained a lot about the tight Federal Reserve policy from 1989 to 1991 when the monetary base for foreign currency, adjusted or unadjusted, was declining. We forecasted a relatively good expansion for the second half of this year, and that has come about.

Now, I don't want to put a lot of weight on forecasts because I don't believe that forecasts—mine or other people's—are very accurate. What we are talking about now, in much of this discussion, is whether there is a great reliable forecasting mechanism available in the monetary aggregates or in any other measure. It would be nice if that were true. Unfortunately, it is not true, so one should not put a great deal of weight on future forecasts. Nevertheless, the base growth has done rather well in forecasting what has happened over the last half a decade or more.

Senator Sarbanes. So you disagree with Professor Friedman?

Mr. Meltzer. Indeed.

Senator Sarbanes. Do you think the money growth has continued through 1992?

Mr. Meltzer. Yes, it has continued.

Senator Sarbanes. It hasn't slowed?

Mr. Meltzer. No. My chart shows that it has been about constant at an average rate of somewhere between 7 and 8 percent.

Senator Sarbanes. Do you think inflation has risen in 1992?

Mr. Meltzer. No. It has declined.

Senator Sarbanes. It has declined?

Mr. Meltzer. Yes.

Senator Sarbanes. On February 2, 1992, you wrote a column, "Why the Federal Reserve's Discount Rate Cut Will Bring on Inflation."

Mr. Meltzer. I think that is——

Senator Sarbanes. That is the heading of the column.

Mr. Meltzer. I don't write the headlines.

Senator Sarbanes. You say in the article, "unless money growth slows soon, inflation will rise."

Mr. Meltzer. Yes.

Senator Sarbanes. Now, you have just told me that money growth did not slow——

Mr. Meltzer. That is right.

Senator Sarbanes. ——and inflation did not rise.

Mr. Meltzer. Yes. My forecast——

Senator Sarbanes. It wasn't a very accurate prediction, was it?

Mr. Meltzer. No, it was not an accurate prediction. I do not make any claim to being more accurate in my predictions than Professor Friedman or other people are in theirs.

Senator Sarbanes. It all comes back to the comment Professor Solow made about being a tenured professor.

Mr. Meltzer. I don't think so, Senator.

Senator Sarbanes. Which means he has a job. Because, you see, you make these predictions and they don't work. I mean, your job continues, you know? But what we are concerned about are these people out there who are unemployed and can't get a job. We are concerned about this job——

Mr. Meltzer. And I am concerned about them too, Senator.

Senator Sarbanes. Well, I cannot——

Mr. Meltzer. But I also think that the other side of that chart is the chart which would show productivity growth. It is important to take account of the fact that the people who are working are working at higher productivity and that is good for their long-term prospects. As I emphasized in my statement, what is important here is that we put these people back to work, not just to get them back to work, but to get them back to work at higher productivity.

Senator Sarbanes. We want to do both of those things. But if you are telling me that you wanted money growth to slow, you said inflation was going to rise. Fortunately, money growth did not slow. In fact, some of us think it should have increased even more. We don't think there is a pressing inflation problem now on the horizon, and we end up with these limited or restrictionary policies, which I think are in part responsible for this large gap between job recovery in this cycle and what we experienced in previous cycles.

David?

Representative Obey. All I was going to say is that, granted, productivity increases are good in the long run. But as Dr. Solow pointed out in his statement, if, in the short run, productivity increases reflect, at least, in part, the fact that companies have been trying to do more with less, then in terms of our ability to deal with the job lag as we come out of this recession, our problem is complicated by that productivity increase and, it would seem to me, would require even more attention to the need, in the short run, to try and make up for the downside of that productivity gain.

Senator Sarbanes. Professor Tobin, suppose we had followed this advice and slowed money growth in 1992, and everything that that would imply, which I assume would be a more restrictive or contractionary monetary policy, what would happen to the economy?

MR. TOBIN. Well, I think we would have had very likely much slower progress on recovery than we did have in 1992.

SENATOR SARBANES. We would have an even worse unemployment problem on our hands?

MR. TOBIN. Yes, worse unemployment problem than we have now, although I must say——

SENATOR SARBANES. And a bigger deficit probably, too. Wouldn't it be a bigger federal budget deficit problem as well?

MR. TOBIN. Sure. I must say that I think maybe monetary policy has not been as potent in a positive direction as it was in previous business cycles. Although they haven't gotten interest rates as low as they should or could have, they have gotten them pretty low. The banks' so-called credit crunch may have attenuated the effectiveness of a given dosage of monetary policy, suggested that perhaps they should have made the doses bigger in order to have the same effect.

SENATOR SARBANES. Mr. Solow, you want to add to that?

MR. SOLOW. No, I don't have anything to add to that.

SENATOR SARBANES. Let me ask you, do you see any valid basis now existing in our economic circumstances that would warrant the Federal Reserve tightening monetary policy?

MR. SOLOW. If you are asking me, the answer is no.

SENATOR SARBANES. Let's assume, as I put that question, that there is a modest fiscal stimulus package that the President makes an initiative. They have been talking in the range of $25 billion to $30 billion. Factor that in as part of your thinking as you look at the economic landscape, Professor Tobin. I know you feel that the fiscal stimulus should be larger than that in order to get the economy back up toward its existing potential, let alone the problem of trying to raise the potential. But do you see any factors that should lead them to contract monetary policy in the face of such a fiscal policy?

MR. TOBIN. In my opinion, the Federal Reserve should certainly not do that. They should let the fiscal stimulus have its chance without tightening monetary policy.

Indeed, I would still favor some easing of monetary policy. If it were true that the Federal Government were about to embark on a $120 billion per year deficit-increasing package, then I could imagine the Federal Reserve having concerns that logically lead them to tighten. But nothing like that is in prospect. Even a stimulus as large as the one that I was proposing in Little Rock would be only 1 percent of GDP. That compares with a 4 percent gap on a conservative Solow side of estimate of potential, or my 5 percent gap. It is a long way from where we are, to where we need to be to get unemployment back down and create the promised number of jobs in the coming four years.

I cannot see a threat of inflation, or overheating in the coming year or two, that should lead the Federal Reserve to do anything to tighten policy.

MR. SOLOW. I would just like to add, Senator, in response to the moderate fiscal stimulus that we have been talking about here and that you just mentioned, if the response to that on the part of the Federal Reserve is to tighten monetary policy, then it is, in effect, working at cross-purposes.

SENATOR SARBANES. Sure. Cut the recovery off at its knees, put the recovery off.

MR. MELTZER. May I make a short comment on that, Senator?

SENATOR SARBANES. I take it you think monetary policy should be tightened; is that correct?

MR. MELTZER. That is correct, but I believe——

SENATOR SARBANES. Because you fear inflation.

MR. MELTZER. Not because I fear inflation but because there is a wide gap between short- and long-term rates, which is now closing by having long-term rates go down.

And that seems to me to be good news for the long-term growth of the economy, to have long-term rates go down during a period of expanding output. If long-term rates were going down because output was contracting, that would not be good news, but going down during a period of expanding output is a sign that people are beginning gradually to become convinced that the present low rate of inflation may be maintained. It is important to get those long-term rates down while the economy continues to recover.

The difference between short and long-term rates is an imperfect measure, but nevertheless a measure of what people think inflation is going to do, not tomorrow, but at some time in the near-term future. It is important to close that gap not by having short-term rates rise but by having long-term rates come down.

That gap has been the widest that we have had. That wide gap is a measure of the lack of credibility that people have about the long-term outlook for inflation. We need to solve that problem, to bring it down if we are going to create meaningful jobs, high productivity growth, do all the things that you want to do. So I don't disagree with you about the goals. We disagree with the method by which we are going to reach them.

MR. SOLOW. Perhaps, Allan recognizes that another reason for long-term rates to stay high is the belief on the part of the market that the Fed is about to tighten credit.

SENATOR SARBANES. Let me just read you this on that very point. This is an exchange with Professor Samuelson. I want to get the comments from each of you on it.

When he appeared before this Committee back on December 30, I put this question to him:

> I want to be clear on one point with respect to this steep yield curve. As I understood your testimony earlier, making reference to the money traders with whom you have been in contact, the high rates on long-term securities, as you understand it from them, is attributable, at least in part, to their expectation that the Fed will tighten monetary policy in order to combat some inflation that they might see coming, or conjure up as coming, as you begin to get a recovery. And, therefore, given that position of the Fed, the longer-term securities are staying at a higher rate; is that correct?

Professor Samuelson said:

> Yes, and it is incorrect in my experience that these smart people in the money market see bottlenecks in the production process, which is going to raise prices as soon as output rises, and see a resurgence of militant union wage activity.

That is the explanation usually given. Mr. Hoskins, former head of the Cleveland Reserve Bank, got into this debate at that time and I said to him:

> How do you square the fact that, by any rational judgment, the apprehension about inflation should be less now than at other times in our history, and yet the yield curve, according to your statement, is the steepest it has ever been? That would only square if one could rationally argue that the apprehension of inflation now is the worse it has ever been. That is clearly not the case going back through the postwar period.

So we have had other periods of time when the apprehension of inflation was reasonably much greater than it is now and the yield curve was not as steep. Doesn't that lend credence to the point that is being made, that maybe a contributing factor to the steepness of the yield curve is a perception that the Fed is going to embark on this policy and that the interest rates are going to go back up again? And I take it that that is the point you were trying to make.

MR. SOLOW. Yes. Yes.

SENATOR SARBANES. What is your view of that point, Professor Tobin?

MR. TOBIN. Senator, I think that these expectations about short rates are a major factor in the formation of long rates, no question about it. And since the Federal Reserve has the control of the shortest rates, then those are necessarily expectations about Federal Reserve policy. Of course, they may arise from expectations of events in the economy that would cause the Federal Reserve to raise short-term rates in the future.

Inflation might be one such reason, and another might be just general congestion in the capital markets because of restoration of full employment and heavy demands for investment. But neither of those things is imminent. They are both a long way off. There is no particular reason to expect the Federal Reserve, on a rational consideration of the economy, to raise short-term rates no matter whether there is a fiscal expansion going on this year or not.

SENATOR SARBANES. Or an economic recovery.

MR. TOBIN. Or an economic recovery.

SENATOR SARBANES. What is happening is, if you start to get an economic recovery and you start to come up and get your head out of the water, then, if they react to it very early on, they push you right back down again.

MR. TOBIN. I think it is very important for Congress and for the President, whatever the economic climate, to have the Fed on his side. Indeed, publicly on his side, so that the rational expectations about what will happen to inflation and capital markets during the next several years will prevail over these fears and nightmares. The markets need to be assured by the Federal Reserve itself that it is not intending to take such action.

SENATOR SARBANES. Thank you very much, Mr. Chairman.

REPRESENTATIVE OBEY. Thank you. Let me ask a few more questions before we get you out of here. This has nothing whatsoever to do with what President Clinton is considering, but it is a question I have had in my mind for a long time.

My predecessor in the Congress was Mel Laird, and while he was in Congress he once proposed a piece of legislation which would have given the President authority to raise or lower tax rates across the board by a given percentage in the interest of being able to manage the economy to a small degree, to weigh against the wind in a countercyclical manner.

Forgetting for a moment the jurisdictional desires of the Congress to preserve its, quote, prerogatives, what would be wrong with giving the President that kind of economic management tool so long as it were limited in scope and so long as he could apply it only uniformly so that he would not be making policy changes, but just trying to adjust in minor periods of economic turbulence?

MR. TOBIN. You are asking two people here who are veterans of an effort by the Kennedy Administration to get precisely that legislation through the Congress. It was actually recommended by President Kennedy on the initiative of his Council of Economic Advisers.

The idea was to agree in advance on a distributionally neutral kind of tax change so that any kind of countercyclical use of taxation would not get bogged down by debate about who was going to benefit, or who was going to pay. I think it was a good proposal then. I think it is a good proposal now.

REPRESENTATIVE OBEY. I am not suggesting that that alone would suffice now because, obviously, you had a very specific set of winners in the 1980s, in terms of who cleaned up under the way the economy has performed and who has cleaned up under the Tax Code, but if were you to get that base rate, I don't see the harm.

MR. SOLOW. The proposal was never that the Congress should not, whenever it wished, make structural changes to the tax laws. This is like old Yale alumni thinking about the Harvard game of 1942, or something. We also had included in the proposed legislation the provision that the Congress could veto the President's action within 30 days or something like that, but the President could act quickly so as to do this thing. And it still strikes me as entirely sensible, apart from the jurisdictional problems.

MR. TOBIN. The proposal included an unemployment "trigger," also used for extension of unemployment insurance.

In the present circumstances, given the priority for an investment-driven fiscal policy for recovery, we might not want a consumption-oriented tax change. Better we should concentrate on the investment tax credit and on public investment.

REPRESENTATIVE OBEY. But do you think it would still be good after that, or even coincidentally with doing that to put it on the books for long-term usage in the future?

MR. TOBIN. Yes.

REPRESENTATIVE OBEY. Let me ask, what is the cost to the country and what is the cost to average working people in this country of following Mr. Meltzer's advice to simply accept the fact that the economy is now growing slowly? Live with that? Don't try to rush it? Let it happen, quote, naturally? Paraphrasing what I think your position is, Mr. Solow, what do you see as the economic and social costs of that policy?

MR. SOLOW. Well, the economic and social costs are primarily more prolonged unemployment than would otherwise be necessary with whatever that means in terms of added stress on families, reduced willingness of individual workers to take risks, greater burdens on children, and so on.

I also think that the costs would be measured in another way. I cannot believe that it is good for the long-term investment plans of business to be told in no uncertain terms that when there is a recession their government proposes to let the recession work itself out however long that takes. I can't think that that would help the long-term investment plans of business, whose main risk often is the cyclical risk of having long periods of bad times.

MR. TOBIN. I think there is some cost in prolonged cyclical lapses from high employment, some cost in lost investment that is not necessarily ever made up. Saving is lost, wasted in unemployment, instead of being used for investment for the future.

But I particularly wanted to add to what Mr. Solow said about the plights of state and local governments, which are fiscal disasters right now. They are short of funds for all kinds of good purposes. They are the vehicles for public investment in infrastructure and education. And prolonging the recession, or risking a triple dip or another in lapse in this recovery would make their situations much worse.

MR. MELTZER. May I comment on that, Congressman?

REPRESENTATIVE OBEY. Okay.

MR. MELTZER. First, I object to your characterization. The economy is not growing slowly. In the last six months, it has grown at 3.75 percent. That is about 1 percent above its average growth rate.

It is important also to note that no one predicted that very accurately. Most people, as late as November, were revising their forecasts downward. So we should have a bit of humility as we look ahead to the forecasts about what is going to happen in 1993. Those were forecasts. The error around those average forecasts is about 60 percent of the average rate of growth of the economy. That is where it has been historically, so we could have a lot of different scenarios in 1993, some better than the forecasts, some worse than the forecasts.

But we really don't know that. What we do know is that we have some ways of getting sustained, durable, high productivity growth in the economy if we don't repeat the mistakes that we made in the 1970s. It took us more than ten years to unwind the policy mistakes of the 1970s. We ought to be cautious before we start to repeat them.

SENATOR SARBANES. Mr. Chairman, could I interject right there, because I think it is very important to keep to keep us in a contemporary factual situation.

Professor Meltzer, I must say to you I don't think it contributes to understanding the problem, to take a 3. 8 percent fourth-quarter growth rate and then say to us, if you look at the growth rates over a long time, this is a pretty good growth rate. I mean, what we want to look at are the growth rates coming out of a recession, which I think is more comparable since the growth rates coming out of a recession are always at a higher rate.

Now, what this chart shows is the average of growth coming out of the four prior recession recovery cycles was 8. 4 percent. Coming out of this one it was 2. 9. Now, this doesn't include the fourth quarter. That would move up at about 3. 8 percent, but this one moved at about 4 percent. So the gap, in fact, would actually increase a little bit from the gap that I am showing you here.

MR. MELTZER. Yes.

SENATOR SARBANES. Now, to come along and give me a growth figure taken over a long stretch of time, instead of a growth figure that is related to the recession recovery cycle, it doesn't seem to me to help us much in trying to analyze where we are. In fact, we have this very large gap in this recession recovery cycle in terms of growth in GNP, compared with previous recession recovery cycles. And, of course, the flip side of this gap in growth is the chart that I showed earlier which shows that we are not recovering jobs. As a consequence, we have all these unemployed people, and we are losing national output which we otherwise could have available to us.

You made short shrift of that in your statement. I thought you dispatched it away rather glibly in terms of the lost output. You referenced it, but you dismissed it. I think that is important. That is output that we now could be achieving, and we could be addressing the unemployment problem.

Thank you, Mr. Chairman.

Representative Obey. Okay.

Mr. Meltzer. May I respond to that, please?

Representative Obey. Okay.

Mr. Meltzer. If your point is that the economy is growing at a slower rate than the average recovery from recessions, and I would assume that is part of your point, then I acknowledge that in my statement.

Senator Sarbanes. Significantly slower.

Mr. Meltzer. Significantly slower. I then gave four reasons why. Let me repeat two of them very briefly.

Many of those recessions which were faster spilled over into inflation. Those were not durable expansions.

As one very bad example, let's take the 1980 recovery, which spilled over into inflation quickly and was aborted as quickly. Not all of them have that record, but many of them have that record. I would like to avoid that because I am interested in seeing productivity growth, good jobs being created, the growth rate of the economy picked up in a durable, sustainable way.

Second, many of those recoveries did not have cutbacks in defense spending. When we have had cutbacks in defense spending, we know that it has taken bits of time, a year to two, to absorb those people into new jobs. I think that we will have the same problem in this defense cutback. And there are some other reasons, but let me not go into them.

Representative Obey. Let me respond by making a couple observations.

First of all, I know of no significant testimony before this Committee which would indicate that there is that kind of inflationary threat on the horizon. Even Dr. Greenspan, whose responsibility it is more directly than any other government official to oversee that, testified just about ten days ago that he did not see that on the horizon. Second, I think you have to recognize that while you raise skeptical concerns about any projections that anybody makes, we recognize that most of those projections already include the assumption that there will be some kind of moderate stimulus package. They build that into their assumptions on economic growth for the future. And, third, it would seem to me that because we do have a downsizing of the defense budget, that is all the more reason to try to be adjusting on the other side.

I would point out that it is my observation that when we went through a similar, and in many ways larger, problem at the end of World War II, I would submit that Harry Truman did not just stand there and watch the military budget become downsized and watch people come home without opportunities for jobs. He created two programs that provided some bridges.

For instance, the GI Bill. It may have been intentioned to help people get an education, but it also was a convenient way to park an awful lot of people in a productive enterprise; that is, enhancing their education and skill levels by going into school for a number of years so that they could be phased into a job market that wasn't ready to provide job opportunities for them immediately. And, second, it seems to me that the housing programs recognized that in addition to meeting the social good, which the FHA and VA housing programs met in those years and beyond, that it also provided a way to occupy a lot of people in productive economic activity while the economy was being shifted from a very heavily worked on footing to a more civilian-oriented situation.

So, to say that our response to the defense downsizing should be to think of doing less to counteract, that seems to me to be strange.

Mr. Meltzer. I suggest that there are a number of things you might do. They just didn't happen to include short-term stimulus, but there are a lot of long-term stimulus measures in my proposals, which I——

Mr. Solow. I would like to add, sir, that the downsizing of the defense budget, in real terms, began about five years ago, and we are long past the time when we are capable of acting surprised and saying, oh, this is happening to us.

Senator Sarbanes. Mr. Chairman, let me just close by underscoring the point I was trying to make for the sake of analysis. In his statement, Professor Meltzer describes the discovery as anemic. I happen to agree with that.

He then goes on to say:

> I would not use that term to describe recent performance. Preliminary data for the second half of last year showed a growth rate of 3 and 3/4 percent, well above average growth for the U. S. economy. I mean, average growth for the U. S. economy for 1992 as a whole, growth was slightly above the historical average of 2.8 percent with only one quarter below the average rate.

We are trying to analyze where we are in terms of addressing this recession. In fact, Professor Meltzer gives himself a backstop on that because he then goes on and says—and I think this is where the framework of analysis should have been: "Of course, the economy must grow at an above average rate during recoveries to compensate for falling out during recessions. So we should not be complacent about the recent record."

Well, I think that is the nub of the problem. And the fact of it is, we have had this enormous gap between the growth out of this recession compared with previous recessions. Obviously, it has to grow above average rates, and it is not doing that. It is doing well below in comparison with these previous recessions. And that is our problem in terms of recovering the jobs. And that is what gives such an urgency, I think, to the President's concern about having a package that is going to give us job restoration. The President understands we have to get jobs back. We have got to get people working and producing.

Representative Obey. I would agree with that.

Let me thank you gentlemen for coming and observing, as this discussion has made quite clear this morning, that we do have a short-term problem which most of us view as being a weak recovery in comparative terms, with the resulting impact on human beings that it has in terms of lost income and wages, and with the resulting impact on the deficit.

I would point out one of the quickest ways that we could reduce the size of the deficit would be to reduce the unemployment level by a percent and a half. You would have a substantial reduction in the deficit, far larger probably than any one specific change which the President will recommend.

And it also seems to me that we in fact have three deficits—the budget deficit, the investment deficit and the growth deficit—which we have to tackle simultaneously. Unless we attack all three, we are simply not going to overcome the deficit in family income which, after all, was supposed to be the goal of economic policy. I believe, based on what the President has said so far and certainly what he said last night, he understands that.

Now, we have heard some macroeconomic advice this morning, largely on how we ought to deal with that problem. This afternoon, beginning at 1:00 p.m., we will hear a panel which will be describing what they feel we ought to do to deal with the investment deficit on the human side of the ledger, which we talked about this morning. And tomorrow we will have another panel which talks about what we ought to be doing about the other pieces of that investment deficit.

If I could just go back to the investment deficit chart before we quit, I think it is, again, important to emphasize that while we deal with that federal deficit, this is a terribly important part of the equation. Any time the government itself—its own budget—has reduced the share of our federal budget, which we devote to long-term investments, by more than 40 percent, it indicates that we have been going in the wrong direction in terms of policies needed to strengthen the economy long term. This is the question to which we will turn to in this afternoon's hearing.

Senator Sarbanes. Mr. Chairman, could I put one final question to Mr. Tobin?

Representative Obey. Okay.

Senator Sarbanes. I am increasingly concerned that the use of these monetary aggregates, as some kind of measure of policy, really don't get at what we need to know, and I am curious as to whether we should be thinking of developing some way in which the Federal Reserve will present its goals in terms of key aspects of the economy. In other words, they are trying to set a monetary policy to accommodate this kind of growth, this kind of employment, this kind of price level, and so forth, so you are actually getting at the real variables that impact on people's lives. Do you see any profit in trying to explore that path?

Mr. Tobin. I do indeed. I can imagine that we could sit here all afternoon with Professor Meltzer and myself, and Bob and you, and not coming to agreement on that. But I do think that it is more important to have the Federal Reserve come to the Congress and express its goals for macroeconomic performance in terms of things that really matter—growth of GNP, what happens to employment and unemployment, investment and foreign balance, and inflation. They should talk with you about their appreciation of the macroeconomics circumstances in which they are making policy, and the general directions in which they hope to move the economy in the coming six months, or in the coming year. The intermediate and operating instruments that they use should be derived from those goals.

Those goals could be discussed by the Congress, the Administration and the Federal Reserve so that there is a coherent macroeconomic plan of fiscal and monetary policy. There could then be a common strategy. The parties would not be working at odds against each other. Then I would leave it to the Federal Reserve to decide by what instruments—interest rates, reserve targets and so on—they would carry out their part in this macroeconomic strategy.

Senator Sarbanes. Thank you very much.

Representative Obey. Thank you, gentlemen. I appreciate it. We will resume at 1:00 o'clock.

[Whereupon, at 12:40 p.m., the Committee recessed, to reconvene at 1:00 p.m., the same day.]

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SUBMISSIONS FOR THE RECORD

PREPARED STATEMENT OF JAMES TOBIN

(Presentation at President-elect Clinton's Economic Conference, Little Rock, December 5, 1992)

The United States suffers simultaneously from two macro-economic maladies. One is short-run and cyclical; the other is long-run and secular. The first is demand-side; the second is supply-side. The first is that spending on goods and services currently falls well short of the economy's capacity to produce them. The second is that productive capacity itself had been falling behind the needs and aspirations of the nation. The first has resulted in a shortage of jobs. The second is eroding the quality and real wages of jobs.

The great challenge of the Clinton Administration will be to provide remedies for both maladies. It won't be easy. The key to job creation in 1993 and 1994 is more spending. private or public, domestic or foreign, consumption or investment. The key to better real wages over the next two decades is faster growth of productivity, requiring greater national saving and investment.

Growth of the capacity of the economy determines the trend of real Gross Domestic Product (GDP) over the decades, across business cycles. Potential GDP at full employment—now about 5 1/2 percent unemployment—grows nowadays at about 2 1/2 percent per year. Half of that is due to the normal increase of the labor force, the other half to productivity. Productivity is growing much more slowly than before 1973, and more slowly than in other economies today. This is the long-run, supply-side malady. We need to raise productivity and the speed of its growth for the benefit of future Americans.

The short-run demand-side problem is that we haven't even kept up with the growth of capacity. 2 1/2 percent is the sustainable growth rate. If (GDP rises at that pace, it will just absorb the influx of new workers and the unemployment rate will remain constant. If GDP grows more slowly or actually declines, the unemployment rate will increase. The 2 1/2 percent sustainable rate, not zero. is par for the U.S. economy. Relative to that par, we've been in recession—call it "growth recession"—for nearly four years; although GDP change was positive in most quarters, growth was usually slower than 2 percent annual rate. That is why unemployment increased by two percentage points, about 2 1/2 million workers. As a result, GDP has by now fallen 5 or 6 percent below capacity.

To catch up in four years, we have to grow faster than the sustainable rate, indeed on average 1 1/2 percentage points faster. GDP growth averaging 4 percent will be needed to bring the unemployment rate back down to 5 1/2 percent in 1996, by creating 8 1/2 or 9 million jobs—for roughly 5 or 5 1/2 million new workers, 1 million persons re-entering the labor force, and the 2 1/2 million now unemployed.

Will this catch-up recovery occur on its own? Or do we need fiscal stimulus to pep up demand for goods and services and for labor? There is, I believe, a strong case for stimulus. The labor market is weaker than the unemployment rate suggests. The number of employed workers involuntarily confined to part-time jobs is abnormally large. Job vacancies, as indicated by the Help-Wanted Index, are extraordinarily scarce. Defense cutbacks and corporate downsizings are destroying jobs irreversibly; to an unusual extent hirings in this recovery will have to be truly new jobs. Although some recent macroeconomic numbers—notably, third quarter GDP—are encouraging, recovery is by no means in the bag. Typically growth spurts in the first year and then tapers off; no such spurt is now evident or forecast. Among other unpromising demand prospects are the slumps in Europe, Japan, and throughout the world, which together with the appreciation of the dollar curtail U.S. exports, the forced belt-tightening of state and local governments, and the sluggishness of business and household investments.

Improved productivity growth recently reported, if not transitory, means that potential GDP is higher and growing faster than estimated above. That would be good news for the long run. But its flip side would be that extra demand expansion would be required to achieve full recovery in four years.

Why can't the Federal Reserve do the job by itself, without fiscal help? One impediment is the banks' "credit crunch." Short-term interest rates are already very low. It may be that the Fed acted so little and so late from 1989 on that, as in 1930-31, they destroyed business and consumer expectations of recovery and let the economy slip out of their grasp. And after all, in virtually every previous cyclical recovery since World War II, monetary policy has had active fiscal help.

Nevertheless, the Fed still has three hundred basis points between here and zero, and they should lower rates further. The new President and Treasury Secretary will want to do their best to induce the Fed to be accommodative and to help reassure the bond markets. After all, no inflation cloud darkens the sky, and congestion of the capital markets is at least as distant as full recovery. Also, we may hope that Secretary Bentsen will not let his debt managers supply the markets with any more long-term high-interest bonds.

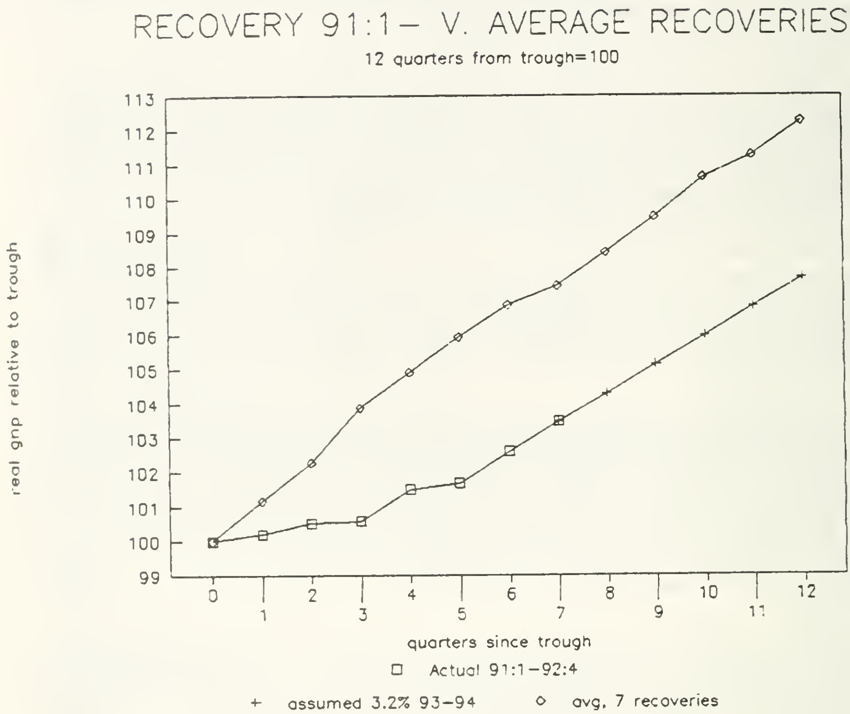
Fiscal policy for recovery is bound to raise the budget deficit temporarily. (Among the virtues of an Investment Tax Credit is that it delivers a big bang of demand stimulus per dollar of lost tax revenue.) I recommend stimulus of $60 billion a year for the two years 1993 and 1991, about 1 percent of GDP, capable thanks to secondary "multiplier" effects of adding 1.5 percent to GDP demand, a modest count relative to the 6% shortfall of GDP from its potential. The ratio of federal debt to GDP, which rose from 25 percent to 50 percent over the past twelve years, would be about one percentage point higher than otherwise. That price is worth paying for assuring a vigorous recovery.

Fiscal stimulus for recovery should be combined with credible deficit-reduction policies to be phased in later, so far as possible enacted in 1993. For deficit control as well as for its own sake, nothing is as important as health care reform. Otherwise federal outlays for Medicare and Medicaid will bust the budget throughout this decade, in particular rising by nearly 2 percent of GDP from 1996 to 2002.

In today's weak economy, immediate fiscal austerity could be counterproductive. It would raise unemployment. It would actually reduce investment for the future, thus doing harm rather than good to coming generations. The story will be different in robust prosperity three or four years from now. Once the economy is again producing at capacity, there will be no room for additional productive investment unless other demands on GDP are reduced—that is, unless the country caves more. Federal deficit reductions are the prime way to raise national saving—provided they occur at the expense of private and public consumption. and provided that the Fed lowers interest rates enough to channel saving into investment rather than going to waste in unemployment.

In the meantime the Clinton administration has the opportunity to provide in constructive ways the fiscal stimulus needed for recovery. The much-touted 1980s recovery, fueled by the most massive deficits in peacetime history, were incurred for defense buildup and for tax cuts for affluent consumers. Those deficits had no lasting payoffs in productivity and growth. In admirable contrast, Clinton programs of private investment incentives and public investments in infrastructure and human capital would leave behind them important permanent gains.

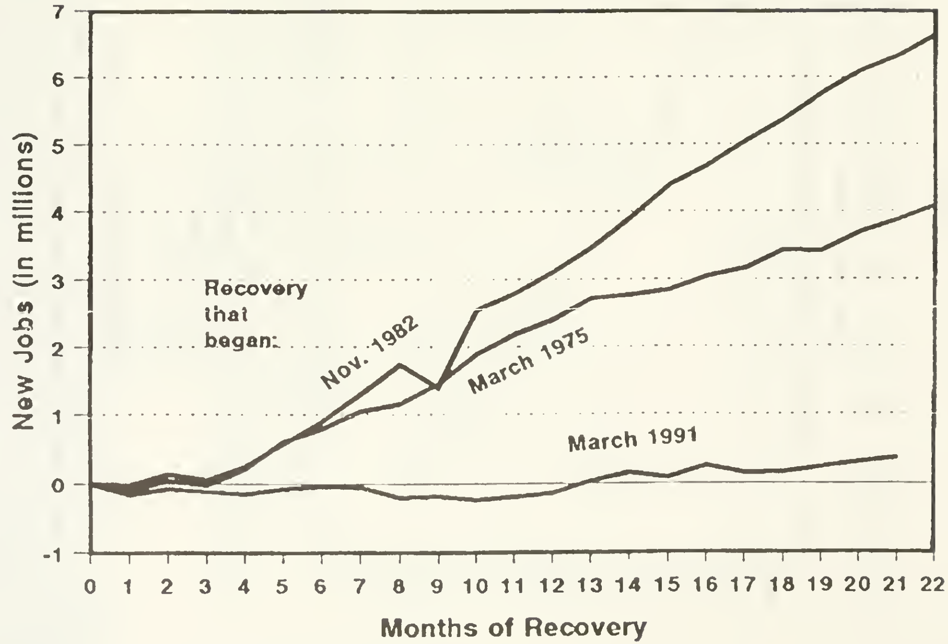
Figure 1



The 7 recoveries averaged in the higher path are those starting from NBER recession trough quarters 1954.2, 1958.1, 1960.4, 1970.4, 1975.1, 1980.3, and 1982.4. For each recovery GDP in 1987 dollars is converted to an index with the trough quarter observation equal to 100. Twelve quarters of recovery are counted, even if a new recession began during that span. The average is compared with the recovery from the 1991.1 trough. Since observations of the current recovery are not available after 1992.4, the five subsequent quarters plotted assume 3.2% per year growth. This is an optimistic assumption, but still leaves the path of the current recovery far below that of the average.

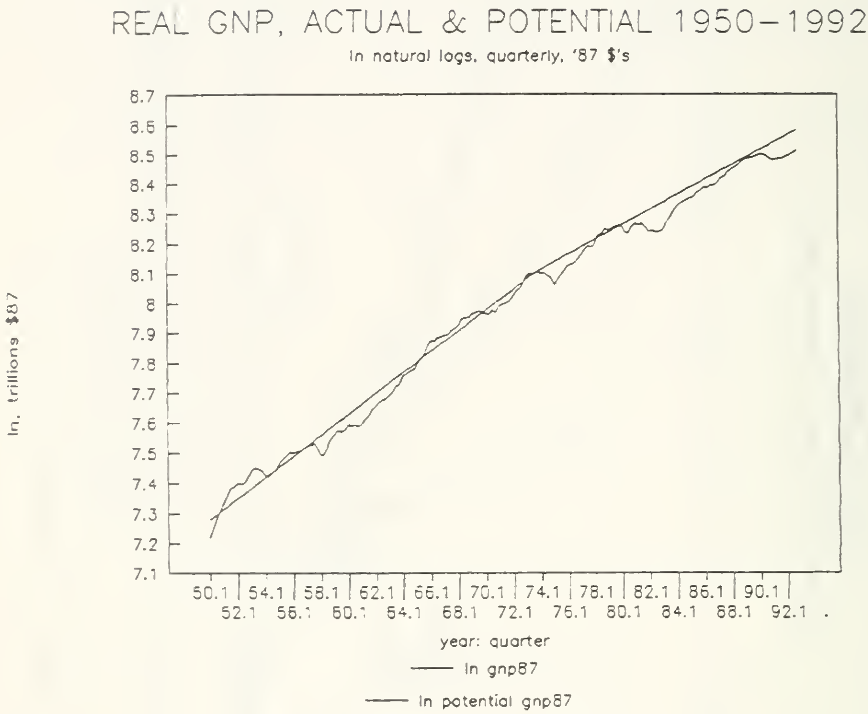
Job Creation

After the Past 3 Recessions



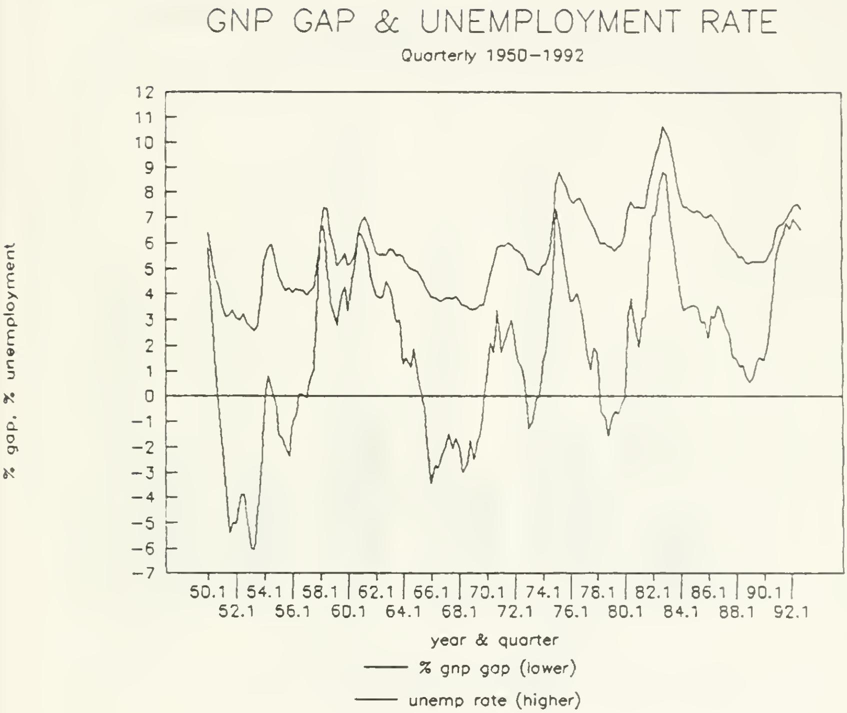
Source: Bureau of Labor Statistics, Joint Economic Committee

Figure 2



Here the smooth path is that of Potential GNP in 198 7 dollars (PGNP), and the wavy path is that of actual real GNP. PGNP is a hypothetical number, conceptually intended to represent the full employment capacity of the economy as a whole in normal peacetime circumstances, In this framework, business cycles are fluctuations of actual GNP around its smooth longer-term trend as shown by PGNP. "Full employment" can be thought of as corresponding roughly to the lowest rates of unemployment and excess industrial capacity consistent with avoiding sustained increases in rates of general inflation. Along a PGNP path, or any path parallel to it, rate of unemployment and capacity utilization are constant. The growth rate along such a path is the economy's sustainable rate, the sum of the rates of increase in the labor force and in productivity per worker, without changes in unemployment rates. In the Figure, the sustainable PGNP growth rate is taken to be 3.5% per year until 1973:4 and 2.5% thereafter. Likewise, the unemployment rate along the PGNP path rises from about 4% in the pre-1974 period to roughly 5 1/4 percent in the second period.

Figure 3



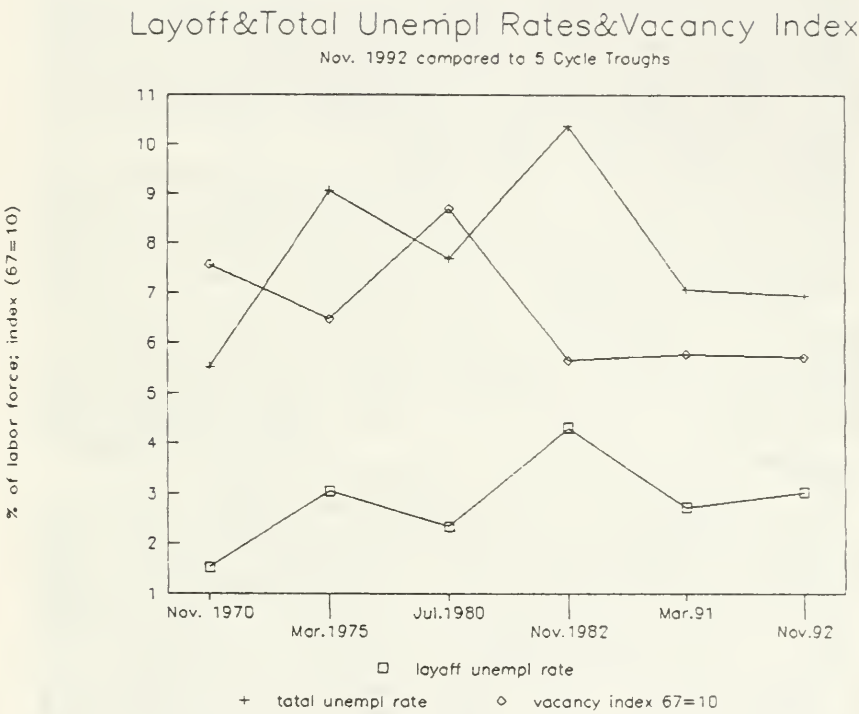
The upper path is that of the civilian UNEMPLOYMENT RATE. The lower path is the track of the GNP GAP, the percentage difference between actual GNP and potential GNP (PGNP), exactly as graphed in Figure 2. The GAP is negative when GNP exceeds its Potential, of which a major symptom is an unsustainably low unemployment rate, as in the periods of war in Korea and Vietnam. As this figure shows, the ups and downs of the two quarterly series are strikingly similar. However, the amplitude of the GAP is two or three times greater than that of the UNEMPLOYMENT RATE. This figure illustrates "Okun's Law," perhaps the most reliable and important regularity of macroeconomics. It explains why it takes a 2 1/2 percent increase in GNP relative to PGNP, plus or minus, to lower unemployment by one percentage point.

Figure 4

The "total" unemployment rate is the conventional civilian unemployment rate, i.e. the count of unemployed workers relative to the labor force. The "layoff" rate is the count of unemployed workers who say that they have permanently lost their jobs, relative to the same labor force. Both are shown for five cyclical trough months, and finally for November 1992, a recovery month 20 months after the last trough. The point is that layoff unemployment currently is at rates usually associated with cyclical troughs and with higher rates of general unemployment.

I am indebted to Professor James Medoff, Harvard University, for this information.

Figure 5



The two unemployment rates of Figure 4 are plotted here, for the same six months as in Figure 4. The additional information is a Vacancies Index, intended to be dimensionally comparable to unemployment rates. It is computed as the ratio of the Conference Board Help Wanted Index to an Index of NonFarm Employment, both with the 1967 average equal to 100. The ratio itself is normalized to make its 1967 value 10, in order to facilitate graphical comparison to the unemployment rates. The point is that recently vacancies have been surprisingly scarce considering the comparatively low unemployment observations in 1991 and 1992.

I am indebted to Professor James Medoff, Harvard University, for this information.

PREPARED STATEMENT OF ROBERT SOLOW

It is a real pleasure to help start off this year's series of Joint Economic Committee hearings, and I thank the Committee for the opportunity. I am not just being polite when I say so, Many people, not just a few economists, hope that the way is now open to thoughtful and cautious activism on economic policy. It is a privilege to be asked to make a contribution to this process

We live in the short run, and I am sure that most of your discussions in these hearings will be about the immediate prospects for our economy, the size and shape of the appropriate fiscal stimulus, if any, and the deficit that came to dinner. We can get to those questions in due course, but I would like to begin by talking a slightly longer-run point of view, focusing on the linked issues of jobs and Productivity. I hope in this way to avoid the danger that is always present in discussions of any kind of policy, that we redouble our efforts as we lose sight of the goal.

You will remember that during the 1980s, at least after the deep recession of 1981-82, the U.S. economy was in one important respect the envy of Europe and much of the world. Between 1982 and 1990 we generated 20 million payroll jobs. We had the luxury of worrying that about 19 million or them were in Service-producing industries, During that same period the advanced industrial economies of Europe experienced only trivial increases in employment. One's euphoria about this contrast gas tempered by the observation that U.S. productivity—output per hour worked in non-farm business—rose by only eight percent during the same long upswing These two facts are connected by a piece of arithmetic: the rate of growth of employment and the rate of growth of productivity add up to the rate of growth of output. Given the path of productivity, we could have had faster or slower growth of employment if we had managed faster or slower growth of output. (It is natural to take the growth of productivity as the "given" in the short run, although that is not quite true.)

We may be seeing the dark side of that success now. Everyone is painfully aware that payroll employment today is still lower than it was in 1990. Despite all the favorable straws in the wind in' recent months, the country has not yet managed a monthly increase in employment large enough to cut into open and hidden unemployment. Even more ominous is the drumbeat of announcements of major layoffs at flagship corporations: IBM, General Motors, United Technologies Sears, and others. In this context, it does not sound like good news that non-farm business Productivity is up four percent in the past two years. Given that pace of productivity growth it would take a considerably faster increase in output to generate a decent number of jobs. It looks as if all that job growth in the 1980s may have been too cushy to last. Businesses, including those large ones, may have added workers that they did not really need. The competitive pressure to cut costs and eliminate uneconomic capacity is now working in the opposite direction.

Any increase in productivity is a good thing when looked at from the cost side. The sort of labor-shedding we are seeing now, the squeezing-out of workers who are associated with capacity that can not earn its way or are not really needed for the efficient operation of viable capacity, is necessary and, in its way, useful. At least it tells us that we have labor resources to use elsewhere in the economy if we can generate the demand for the goods and services they might produce. But labor-shedding is a lot less promising than the productivity gains that come from the appearance of new capital and new technology and that themselves represent additions to state-of-the-art capacity. We would be better off in every run if we were experiencing bore more of that kind of productivity gain.

These questions are central to an evaluation of the current state of our economy and the room it offers for expansionary fiscal and monetary policy. They are part of the thought behind thoughtful activism. We know that our economy is not using all of its capacity to produce and not employing enough of its available labor. The Federal Reserve's Index of Capacity Utilization in Industry stands at about 79 percent, whereas it was above 84 percent in the first half of 1989. To frame a policy we need a notion of how much higher GDP could be this year and next without pushing up against the barriers that could revive inflation.

Suppose we take 1988, when the civilian unemployment rate was 5½ percent, as a reasonable benchmark. How fast has potential GDP been growing in the last five years? Experts differ: 2.0 percent a year is on the low side and 2.5 percent a year is on the high side. Most of the model-builders would settle for something in between. Proceeding that way suggests that the current gap is about four percent of GDP, meaning that we are about $250 billion short of our potential production. The history that I was sketching a minute ago suggests that there may be a little extra uncertainty in these estimates, with the cushion being perhaps a trifle bigger than it looks

Now what about the immediate future: how fast will potential GDP rise in the year ahead? A pessimist would stick with two percent, an optimist might be a tad below 2½ percent. I will opt far 2¼ percent, recognizing that all this smacks of more accuracy than one can hope for. If actual GDP grows by 2¼ percent during the four quarters of 1993, the gap between actual and potential will still be 4 percent early in 1994, and the unemployment rate will regain near 7.1 percent. It would take faster growth of GDP to narrow the gap and reduce unemployment. Every increment of one percent to the 1993 growth rate eats up One percentage point of the initial gap, and reduces the Unemployment rate by four- or five-tenths of a point.

The beat mainstream forecasters now expect real GDP growth of 3.2-3.4 percent in 1993. Most of them are busy shading those forecasts upward because recent bits of news have been pretty good, though not overwhelming, It is important to realize that these forecasts already presuppose a shall stimulus package early this year, generally in the range of $15-20 billion.

If that story were to come true, you would be back here a year from now looking at & GDP gap of almost 3 percent and an unemployment rate near 6.5 percent. I suppose you could say that things were getting better, but I would award only a gentleman's "C" to that kind of performance. There is enough slack in the economy to warrant a more aggressive approach, The payoff would be higher output, more jobs, with little danger that inflationary pressure would return. It seems to me that 4+ percent GDP growth in 1993 is a fairly conservative target for policy. That would require a stimulus package near $3s billion and accommodative monetary policy, A year from now the gap between performance and potential would be cut nearly in half and the unemployment rate would probably be nearer 6 percent than 6.5. I emphasize that this is a reasonably cautious approach. It would leave some slack in the economy, and something to think about for 1994. There would be room for the unemployment rate to come down sole more.

Now I will confess that I am an expansionist at heart. If the choice were really mine, I would probably go for a bit more than I have recommended so far. Deep down, I do not really believe that an economic expansion is like a popsicle in the sense that the slower you lick it, the longer it lasts. I think there may be more slack than the standard figures allow. But I am putting aside my natural aggressiveness and trying to be mature.

If I can take a minute or two more, I would like to say something about the composition of a stimulus package. The general principle is that we would be trying to favor investment at every turn, at the expense of consumption. An investment tax credit for equipment should definitely figure, and so should a permanent R&D tax credit It would add effectiveness if the ITC were temporary, or at least had its rate tapering from a higher temporary rate to a lower permanent rate, I would vote for some productive infrastructure, but I would not go hog-wild on what is rapidly becoming a buzzword. The goal should be to do those things that enhance the productivity of private production. Most of those things will involve maintenance, repair, and the proper pricing of congested facilities, Monuments are part of the problem, not part of the solution. My hopes for faster growth of potential ride primarily on industrial equipment, industrial R&D, and a higher-quality labor force. Expenditures on those items are almost sure to do good.

Timing is everything. The most effective time for stimulus is soon. The sooner the economy picks up momentum and gets closer to capacity the sooner it will be possible to turn to reducing the deficit, and providing domestic saving for what we all hope will be a permanently higher rate of investment.

I want to make only two general points about the deficit-reduction phase of current policy. The first is that the credibility of the program is far more important than another $10 billion added to or subtracted from the target deficit 4 or 5 years down the road. The deficit-reduction part of the program should be definite, detailed, concrete and specific about the taxes to be increased and the expenditures to be cut, and when. It is hopeless if you are seen just to be saying "Yes, dear."

The second point follows from the first. Once you and the Administration commit yourselves to a path of deficit reduction, you will have surrendered your ability to respond to macroeconomic surprises by making short-run adjustments to macroeconomic policy. You will have lashed yourselves to the mast, like Ulysses and the Sirens, and for much the same reason. Macroeconomic stabilization will be in the hands of the Federal Reserve. You should make damn sure that the Federal Reserve understands and accepts its responsibilities for our economy. Treasury debt management can help—as it can and should help right now by shortening the average maturity of the debt—but the Fed will be the main player.

PREPARED STATEMENT OF ALLAN MELTZER

The economy continues to expand as we enter 1993. In contrast to the many gloomy forecasts and interpretations of statistical data, that captured the headlines, last year, this growth cannot be explained as mainly the result of special, non-repeating factors. "Special factors" did not work one way; they include the cutback in defense spending which has worked to slow the recovery.

Your letter describes the recovery as "anemic". I would not use that term to describe recent performance. Preliminary data for the second half of last year show a growth rate of 3-3/4%, well above average growth for the U.S. economy. For 1992 as a whole, growth was slightly above the historical average of 2.8% with only one quarter below the average rate. This performance hardly justifies the mountains of paper that have been used to describe the economy as stagnating or anemic or to forecast second and third "dips" into recession that, we now know, did not occur.

Of course, the economy must grow at above average rates during recoveries to compensate for falling output during recessions, so we should not be complacent about the recent record. But we should also avoid additional short-term stimulus based on faulty interpretations. Policy in 1993 should concentrate on encouraging sustained growth and productivity to continue the very promising improvement in productivity achieved during this recovery.

There are at least four reasons why the recovery has been slower than the postwar average. First, many of the earlier, more rapid cyclical expansions laid the seeds of future inflation followed by disinflation and recession. The main reason: excessive money growth in the early quarters of recovery later spilled over into inflation. In the 1960s and 1970s, and again in 1985-86, excessive money growth encouraged rapid spending growth, so that within a few years we had to choose between rising inflation and either slow growth or another recession. Remember the Carter years? Second, mild recessions are typically followed by slow recoveries. Despite many fanciful allusions to the Great Depression, the 1991 recession was one of the postwar era's mildest. Hence the recovery should have been expected to be—and has been—mild. Third, the recovery has labored against sizable defense cutbacks. It has not been possible to beat swords, tanks and airplanes into plowshares or machine tools without making sparks. The worst performance in this recovery is concentrated in California and the Northeast—where defense industries and electronics have reduced employment much faster than peacetime jobs have been created. The 1991-92 experience is broadly similar to that of the Korean and Vietnam defense cutbacks. In those experiences, it took at most 2 years to absorb most of the former defense workers. Fourth, falling real estate prices have been a problem for banks from \ustralia and Japan to Britain and the U.S. The Fed met this challenge with moderate monetary expansion that lowered interest rates but did not reflate real-estate prices. Lower interest rates improved banks' profitability (probably sparing us the cost of a bank bailout) and let many property owners refinance with lower carrying costs. Avoiding reflation preserved the benefits of lower inflation and encouraged the cuts in long-term interest rates that are essential to the transition to lower inflation. These reductions in long-term rates have continued in 1993.

There are costs to a slow recovery but, so far, the costs have been small and there are some offsetting benefits. The long-term benefit of a cutback in defense spending is the resources released for private use. Until the recent slow recovery, many critics wailed about our low saving rate. It is too soon to know whether slower growth of consumer spending during this recovery indicates transition to a higher average saving rate or is a temporary change.

Inflation has slowed. Slower inflation has many benefits. The rate of wage increase is now aligned with productivity growth. Unit labor costs for U.S. industry have fallen relative to foreign competition, so that exports have continued to grow despite recessions in many overseas markets. Lower inflation reduces the tax on durable capital that results from the failure to index depreciation allowances. If low inflation is sustained, it will be a lasting benefit for capital-intensive industries. It is beyond logic to suggest that the government should offer firms an investment tax credit while raising the hidden tax on capital by increasing future inflation.

The best available evidence suggests that long-term growth is not changed by the slow pace of recovery. The difference between the recent 2-3/4% or 3-3/4% and a more rapid 4% or 5% recovery will be made up in future years. A durable recovery and prolonged expansion is important for making up the difference. Future income is not equivalent to current income, of course, so there is a cost to slow recovery. But the cost is only a small fraction of the difference between 2-3/4% and 4% growth for a year or two. And if inflation continues to decline, the loss will be compensated in whole or part by the benefits of lower inflation. And low inflation will extend the years of expansion.

The Role of Monetary Policy

Some critics of the Fed, and some members of this committee, have been critical of the slow growth of a particular broad measure of money known as M2. In the past, M2 growth has been a reliable indicator of long-term growth of nominal GDP. There is no reason to believe this long-term relationship has changed.

However, the short-term relation between the growth of M2 and the growth of nominal GDP has always been subject to relatively large departures from the long-term relation. Forecasts of near-term spending based on M2 have often been subject to relatively large errors. The same is true of the more complex interactions in large-scale computer models containing hundreds of equations. Indeed, all short-term economic relations are subject to large errors. Few forecasters predicted the jump in GDP growth in the second half of last year. Until November, some were still revising downward their forecasts and predicting a return to recession in the 4th quarter. It would be a mistake to give credence to the cacophony from these croaking Cassandras. We should choose policies that promote sustained growth with low inflation, not short-term recovery.

There are other reasons for giving little weight to the recent sluggish growth of M2. I will mention two.

The first, repeats that the short-term relation between M2 growth and spending has always been subject to large fluctuations. There is nothing particularly striking about the size of the recent differences between growth of M2 and spending. So, it is not prudent to put heavy weight on recent short-term growth of M2 in the absence of other supporting evidence.

Second, other measures of money do not show the same pattern as M2. Money issued by the Federal Reserve is called the monetary base. The base consists of the reserves that banks hold and the currency that we all use. Every stimulative action to increase money and credit increases the amount of monetary base outstanding. And, when the Federal Reserve reduces the monetary base, measures of money and credit fall.

The base and all measures of money include holdings of U.S. currency by foreigners. Much of this currency is held outside the U.S. It is not used for domestic spending, so it does not affect U.S. GDP. Foreign holders of U.S. dollars include citizens of Eastern Europe, the former Soviet Union, and Latin America who seek to avoid the heavy cost of inflation in their own countries. Criminals, including drug dealers, use currency extensively. Their transactions do not affect reported GDP.

For some time, economists have known that the dollars held abroad are a substantial fraction of total currency circulation. Estimates based on shipments from the United States or guesses based on observation of the volume of dollar transactions in countries like Russia, Poland or Argentina suggested that perhaps 50% of U.S. currency was outside the country. A recent study raised the share of foreign holdings to nearly 60%. Foreign holdings have been growing about 8 to 10% a year. Since these holdings do not affect U.S. GDP, growth of domestic currency held abroad should be removed from the monetary base.

The chart shows the relation between growth of spending (GDP) and growth of the domestic monetary base—the monetary base net of estimated foreign holdings of U.S. currency. The chart compares the growth of spending (at annual rates) in a given quarter to the annual growth of the domestic base for the period ending six quarters earlier. Like all such relations, this one is subject to change. If the relation holds, growth of the domestic base predicts growth of spending in 1993. I read the chart as saying that—contrary to the current critics—the Fed eased money throughout the current recovery. There is now considerable monetary stimulus.

The message for the future is that continued growth of the domestic base at recent rates will be adequate to sustain recovery and will raise inflation, perhaps by 1994. Now is the time to stabilize the economy and prevent that increase. Prudence calls for about 2% less growth of the domestic monetary base than the average of the last two years. This would lock in the gains against inflation brought about by the tight monetary policy from 1989 to 1991 and contribute to a durable, expansion with low inflation. It would avoid repeating the counterproductive policies of the 1 970s that led us from boom to inflation to bust.

PRODUCTIVITY AND EMPLOYMENT

Productivity growth in 1992, 3% from 4th quarter 1991 to 4th quarter 1992, was the largest increase in twenty years. In manufacturing, reported productivity growth has shown improvement for almost a decade but service sector productivity has not. Recent estimates suggest that, after falling through the 1 970s and 1 980s, service sector productivity has shown a sustained increase since early 1990. Service sector output per private service job—a broad measure of service sector productivity—reached a peak in 1976, declined until 1st quarter of 1990, and has now advanced 5-1/4% from that base to recover in 2-3/4 years almost the entire decline of the previous 13 years.[1]

This recovery of service sector productivity growth is very welcome. Productivity growth is the necessary condition for sustained growth of real incomes and living standards. During the postwar expansion, the service sector has been by far the largest source of new jobs. This will continue to be true. Consider this: the Federal Reserve's index of manufacturing production increased from 18 in 1946 to 110 in 1992, but the number of production jobs in manufacturing are no different now than in 1946. Most of the 67 million jobs created since 1946 are in the service sector.

Productivity growth not only raises standards of living, but the historical record suggested to Simon Kuznets earlier, as it has to me recently, that over long periods economic growth narrows the spread of the income distribution. Everyone gains from growth but lower income-earners gain relatively more so that income differences narrow slowly but steadily. In the 1980s, this long-term relation between growth and income distribution was disrupted, mainly by changes in returns to education that worked to widen the income distribution. I believe the long-term relation will continue to hold. To raise real incomes and spread the benefits widely, we should choose policies that have long-term benefits. I make some suggestions below.

The opposite side of increased productivity growth is the slower growth of employment during the recovery to date. When combined with the loss of jobs in the defense and defense-related industries, we get below average growth in employment and the highest unemployment rates concentrated in the states with larger defense related activities. For 1992, the average unemployment rate in the ten states with heaviest concentration of defense spending was considerably higher than unemployment in the other 40 states.

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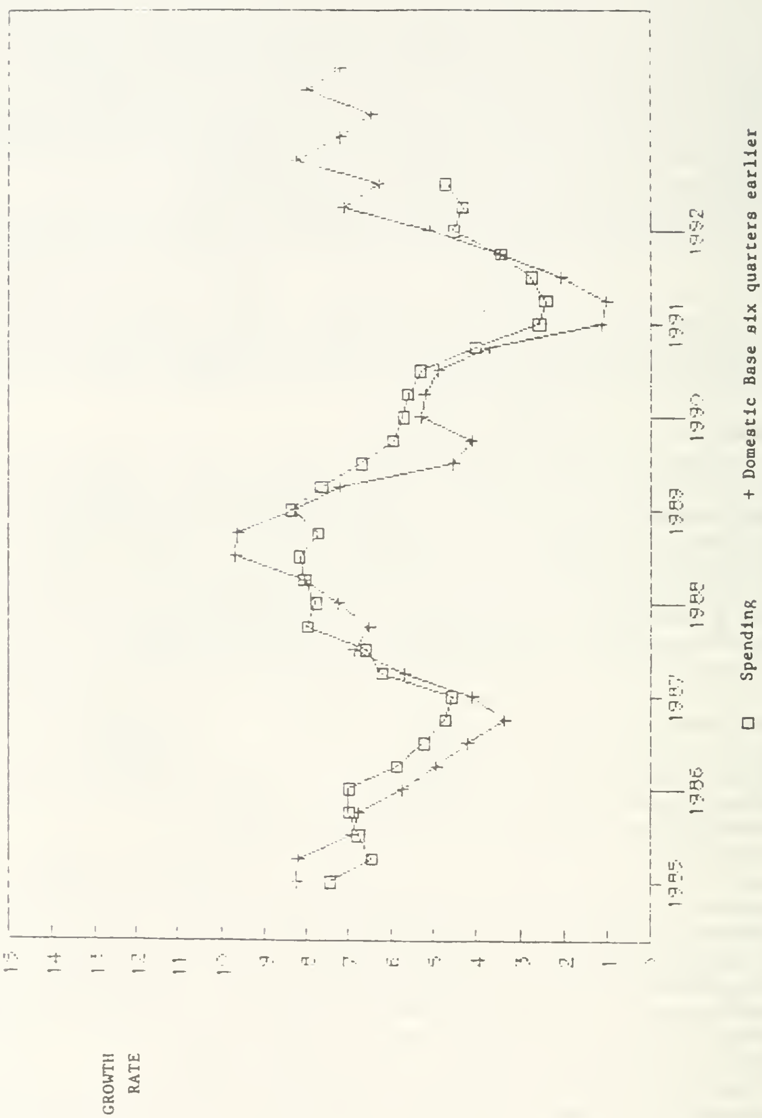
[1] Based on service sector output per private sector service job in 1987 dollars. Service sector output is real consumption of services minus real net export of services. Data from H. Erich Heinemann, Ladenburg, Thalman, Co., NY.

GROWTH RATE OF SPENDING AND DOMESTIC MONETARY BASE
(GDP)



POLICIES FOR GROWTH AND PRICE STABILITY

Much current discussion suggests that the most urgent necessity is to reduce the deficit while increasing spending to provide short-term stimulus. I do not share that view. The recovery will continue without additional short-run stimulus. The reported deficit is poorly measured and overstated. The budget deficit is not as much of a problem as is widely repeated.

More important, and deserving of more attention, is how money is spent, how resources are used, and how the deficit is financed. If we as a nation, incurred the same deficits, but used all of the borrowed money for productive investment in human and physical capital, we would be much richer and would have higher living standards. The economy would generate revenues sufficient to reduce debt in the future.

Public policy has discouraged investment in several ways. Depreciation is not indexed, so inflation is a tax on invested capital, particularly long-lived capital. The 1986 tax act shifted taxes from consumers to owners of capital. Earned income—including saving—is taxed and is almost certain to be taxed at higher rates beginning this year.

Taxing saving is not a way to encourage growth and raise living standards. Taxes should be shifted from earned income to consumed income. This could be done, most readily, by allowing taxpayers to subtract their annual saving from adjusted gross income and levying the tax on the remainder—spending or consumed income. This change would increase saving. Corporations should be allowed to write off all or most of their purchases of machinery and equipment. This would increase productive investment and productivity.

Encourage general research and development and improvements in the quality of education and training by promoting competition in schooling and by increasing incentives for learning. In many countries, school grades and performance are important for getting a first job. This encourages effort and learning. This is not true in the United States. In am told that one reason is that our laws would treat such information as evidence of discrimination.

The choices you make will be important, but often your most important decisions are what you reject. This is particularly true now.

Avoid the drift into protectionist policies and reverse the quotas and voluntary restraints that burden consumers, lower living standards, reduce competition and threaten the world trading system. The United States has led the world through nearly 50 years of growth. More people in more countries have seen living standards rise by larger amounts than in any previous period. The most favored nation principle that started here in the U.S. Congress, and multilateral tariff reduction led by the U.S., were major forces producing this achievement.

Now, many in this same Congress want to turn back toward protectionist policies that are costly to us and destructive of the rules of open trade. They urge policies that are inimical to growth and that lower living standards here and elsewhere.

Much of the U.S. economy is in a strong, competitive position. Unit labor costs in many industries have fallen far below comparable costs abroad. This is the time to benefit our own economy and the world economy by adopting rules for freer and more open trade and by strengthening enforcement through GATT.

Lower payroll taxes would encourage employment. A higher minimum wage and more mandated benefits raise the cost of employing labor and reduce employment.

Avoid, the temptation to develop an industrial policy. The private sector is not always right, and the public sector is not always wrong. What matters is the batting average over years or decades. Be happy that you did not subsidize investment in the Supersonic Transport, HDTV, the fifth generation computer and many other well-advertised projects that were at one time or another claimed to be critical for our prosperity. Productivity growth occurs in both old and new industries. Steelmaking, tire making, bread baking, and other industries are as capable of increasing standards of living as the more talked about new industries. Beware of the Marxist fallacy, pushed by proponents of protectionist policies, that progress is limited to the so-called "leading sectors".

The policies I urge on you are policies for growth and higher living standards, not short-term stimulus. If you remove barriers to trade, avoid costly and burdensome regulation of commerce and industry, encourage improvemei ts in the quality of education for all, reduce taxes on saving and investing, and insist that the Federal Reserve maintain the near price stability, that is now ours, growth and living standards will continue to rise as they have throughout our history. And jobs will increase and opportunities expand, as they always have.

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THE 1993 ECONOMIC REPORT OF THE PRESIDENT: INVESTING IN PEOPLE

THURSDAY, FEBRUARY 11, 1993

CONGRESS OF THE UNITED STATES,
JOINT ECONOMIC COMMITTEE,
Washington, DC.

The Committee met, pursuant to notice, at 1:00 p.m., in room 2359, Rayburn House Office Building, Honorable David R. Obey (Chairman of the Committee) presiding.

Present: Representatives Obey and Wyden; and Senator Sarbanes.

Also present: Glen Rosselli, Charles Stone, William Buechner and Lee Price, professional staff members.

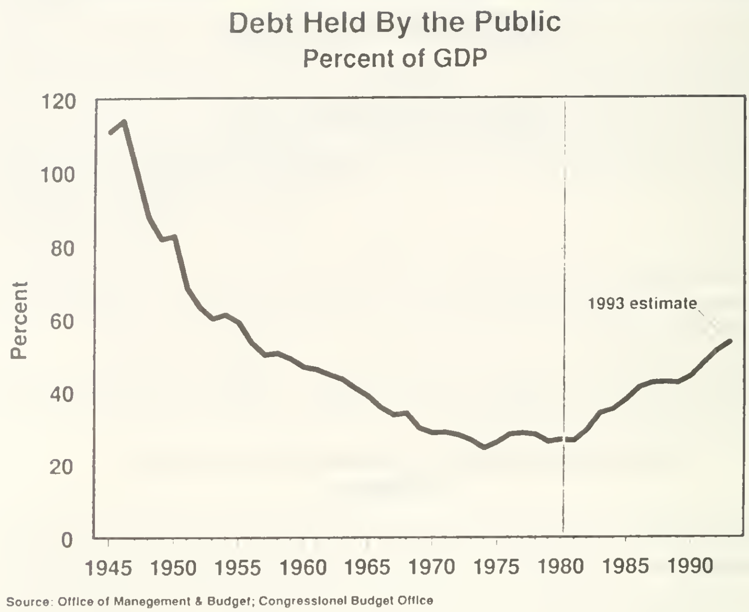
OPENING STATEMENT OF REPRESENTATIVE OBEY, CHAIRMAN

REPRESENTATIVE OBEY. This morning, I explained at the outset of our morning hearing that as the President is grappling with his final budget and economic choices, at least the first chapter of which he will be presenting next week, I thought it would be good if Congress could be examining some of those same questions so that we can understand the complicated nature of the choices available to the President. And I believe, as I said this morning, that the best way to understand the problems that we confront is to recognize that this country essentially faces four deficits.

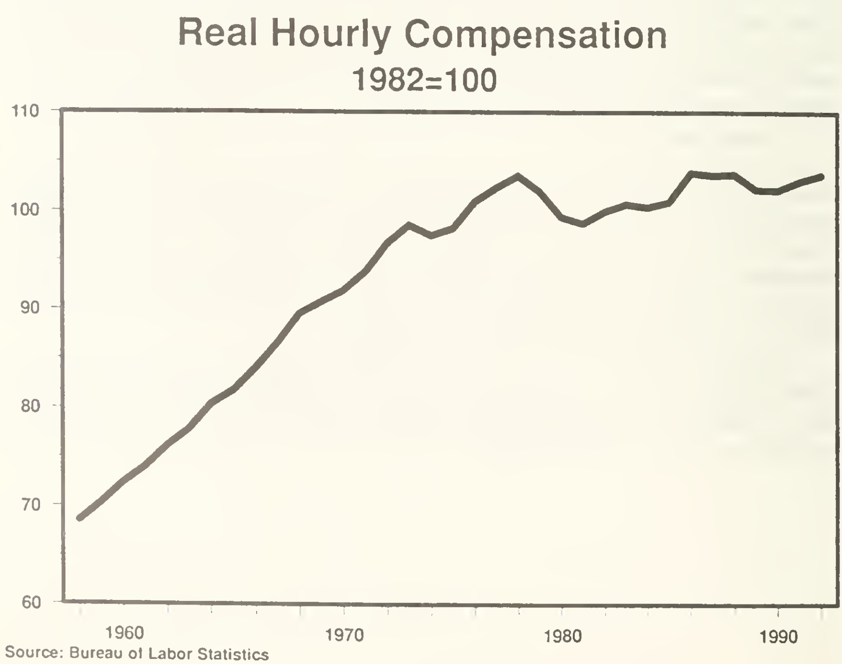
It faces the budget deficit, which is well-known and often discussed. It faces a growth deficit because our economy is growing much more slowly than it has coming out of past recessions. Third, it is facing an investment deficit in both the private and public sector, and the result of all of that has been, certainly, a family income deficit, with a tremendous squeeze being put on family income—certainly over the last few years and, in my view, at least perspectively, beginning in 1973.

To retrace what we said in this morning's hearing, I think this chart illustrates that, with respect to the federal deficit and the public debt which that resulted in, we had a steady decline in the amount of debt as a share of annual national income, during the years going down to about 1973. It then stopped dropping in 1973 through about 1980, starting with the first oil shock in 1973. And since 1980, as a percentage of our annual national income, our national debt has just about doubled. (See chart below.)

It dropped down from over 100 percent of our annual income right after World War II, down to about 24 percent in the 1970s, and now it is back up near 50 percent. We also have some specific impacts of all of these deficits on income, and I want to get to these.



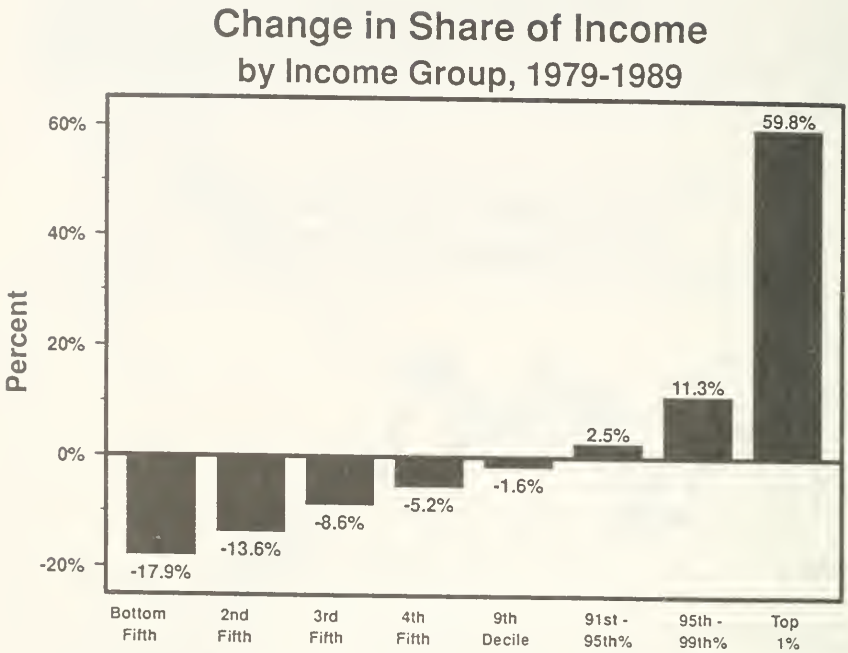
This chart shows what has happened to real hourly compensation from roughly 1958 through today. What this chart demonstrates is that if you take all workers in the country and include wages and fringe benefits, we topped out in 1980, and have been struggling along since then trying to move it up, with not much success. (See chart below.)



If you break this out a little bit and take a look only at the nonfringe benefit direct wage compensation to everybody in the economy who is not a manager, you see that average hourly earnings have declined from roughly $7.80 here in 1986 and 1987, down to about $7.45 today. I think that indicates what the recent trend has been. The problem has been that this has not fallen equally on Americans. (See chart below.)

This chart demonstrates what changes have occurred to people at various income groups in terms of their share of national income. If you take a look at the changes between 1980 and the end of the decade, you see that the poorest fifth of Americans saw their share of national income drop by over 15 percent. You see the second poorest share of Americans, whose income dropped as a share of national income by 12 percent. The middle third dropped by around 7 percent. (See chart below.)

The second richest fifth, if I can put it that way, had a small drop. It is only after you get to the 91st percentile in terms of income that you see that there has been an actual increase in their share of national income over the decade. It is only when you get to the top 1 percent that you have really cleaned up in terms of what is gained or lost, given the way income has been redistributed in the 1990s.

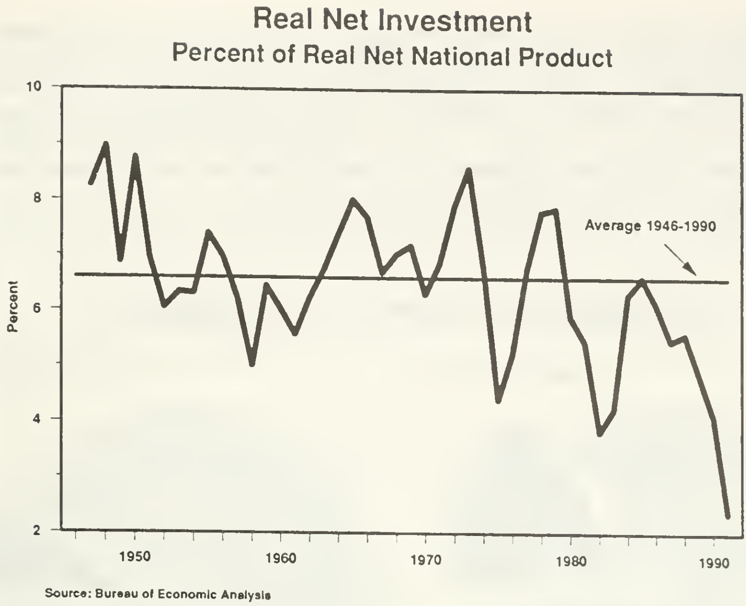


Source: Joint Economic Committee

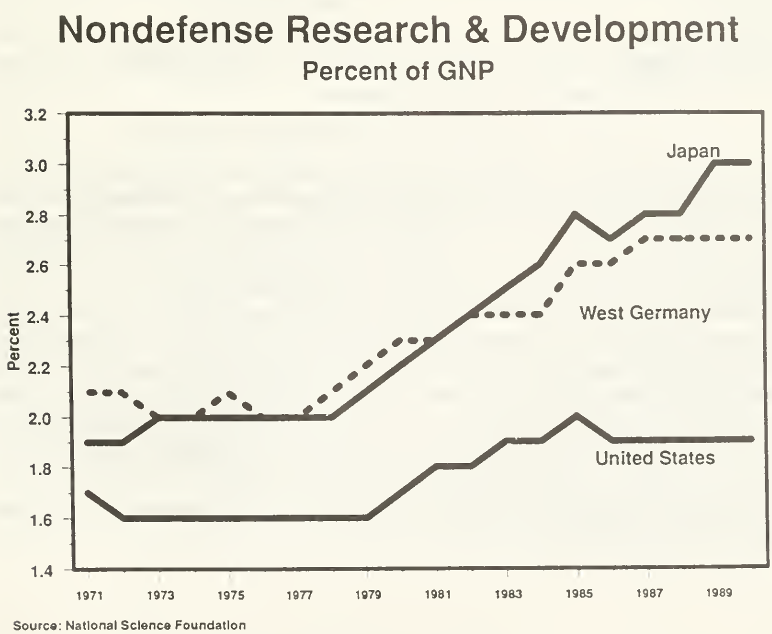
I remember in the 1980s that many people used to talk disdainfully about income redistribution. By that they meant that they were offended because income had been distributed down the income scale. As you can see, in the last decade or more, we haven't had that problem. It has been just the reverse —in the wrong direction, in my view.

I believe that in addition to all of our other economic problems, these problems are caused in large part because we have a real gap in what we are investing in comparison to what we should be investing.

This chart demonstrates that the average net investment as a percentage of national output from 1946 through 1988 averaged a little above 6.5 percent. As you can see, since the mid-1980s, it has really fallen off. (See chart below.)

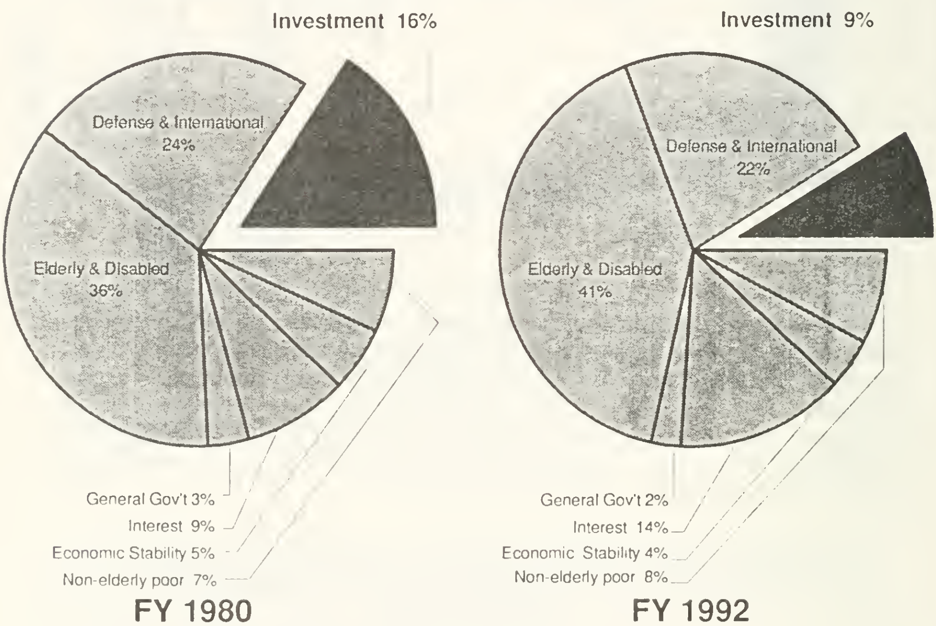


If you take a look at just one small piece of that, our nondefense research and development budgets, on a comparative basis with our main economic competitors, you see that from 1970 through today, West Germany—represented by the blue line—has increased substantially their investment as a percentage of their national income. Japan has done the same—as represented by this green line. Whereas, the United States has largely, with a small upward climb here between, say, 1980 and 1981, stabilized at a level far below that of our principal competitors. (See chart below.)



If you take a look at government investment, which is part of the investment over which we have some control, as Members of Congress, you see that we have had a tremendous change since 1980. This pie indicates that 36 cents out of every dollar in 1980 went to the elderly and disabled through government programs. Today, that is about 38 cents of every dollar, so that has grown by two cents. If you take the share of the budget that went for the nonelderly poor, that was 7 percent of the budget in 1980. By the end of the decade, it had dropped to 6 percent of the budget, six cents on every dollar. (See chart below.)

Shrinking Federal Investment



Source: Office of Management & Budget, Joint Economic Committee

Economic stability, unemployment compensation, and things like that, are countercyclical to keeping the economy moving when it is sliding down, and which you just continue when the economy increases activity—economic stability in 1980 represented five cents out of every dollar. Today it represents about five cents of every dollar, so that has not changed much.

President Clinton announced yesterday that he is making significant reductions in the White House budget. To put that in perspective, we need to see that the general government—which means what it takes to run the FBI, the IRS, just to run the agencies of government—took four cents out of every dollar in 1980. It was taking two cents out of every dollar by the end of the decade. So that had been cut in half as a percentage of the federal budget.

Defense, which was about 24 cents out of every dollar in 1980, was about 27 cents out of every dollar by 1990. It had been a little higher and had been coming down by that time.

The two main changes that you can see here would be interest, which was nine cents out of every dollar in 1980; by the end of the decade it was taking 14 cents out of every dollar, and it has changed a bit since then. And this is the piece we are talking about today.

Direct government investment, and by that I mean investment in kids by way of education, investment in health care—not health delivery, but health research—investment in physical infrastructure, highways, the transportation systems, the sewage treatment plants, the things that make a community function more efficiently; and the investments that we make in other direct areas —in science, for instance, to try to stay on the cutting edge of technology—that portion of the federal budget has shrunk from 15 cents out of every dollar in 1980 to nine cents out of every dollar today, a more than 40 percent drop.

And, in my view, we are not even going to successfully get the federal budget deficit down unless we recognize the need to begin immediately reinvesting in the things that we need to be investing, in both the private and public sector. And I know the President is looking at that, too.

This morning, we received some macroeconomic advice from people who were telling us what they thought the overall economic policy ought to be. This afternoon we are going to be hearing from four people who will be telling us what they think we can do to invest on the human side of the ledger. Tomorrow, we will be hearing from witnesses who will be telling us what our policy ought to be with respect to other kinds of investments.

I am very pleased that we have with us today, Ray Marshall, professor from the University of Texas, LBJ School of Public Affairs; and former Secretary of Labor; and James D. Weill, general counsel for the Children's Defense Fund.

We had hoped to have Bob Greenstein here, director of the Center for Budget Policy Priorities, but he has been taken ill. In his place, we are pleased to welcome Isaac Shapiro, senior research analyst, Center for Budget and Policy Priorities. We also have with us Richard Vedder, professor from Ohio University.

Let me stop at that point and ask Senator Sarbanes or Congressman Wyden if they have any comments that they want to make before we proceed with the witnesses.

OPENING STATEMENT OF SENATOR SARBANES

Senator Sarbanes. Mr. Chairman, I will be very brief. I am very pleased to be here. I think this is a very important hearing which you have scheduled this afternoon, following on the one this morning.

Obviously, the issue of people—as the President would put it, putting people first—is a very important item on the American agenda; and I am pleased to see this panel. Without derogating the other members of the panel, I do want to say what a pleasure it is to see Ray Marshall before the Committee, who was an extraordinarily effective Secretary of Labor, and has continued through his work and his study to make a very significant contribution to the betterment of our society.

Thank you very much.

OPENING STATEMENT OF REPRESENTATIVE WYDEN

Representative Wyden. Mr. Chairman, I will be very brief as well. I want to associate myself with your remarks as well, because I think they were very much on point and very timely.

I am particularly troubled about the increasing number of individuals who are being laid off permanently, and I think we are seeing that in the downsizing of major corporations—IBM, Boeing, Sears, General Motors. It is a particularly distressing trend, and one with great implications in public policy issues before the Committee.

For example, one area that I intend to explore with Mr. Marshall, who I know has studied the unemployment system at great length, is that the unemployment system was really designed, I believe, to deal with essentially cyclical unemployment—unemployment where, in effect, there was a downturn or a business cycle that caused layoffs, and people at the end of the cycle get back into the ball game and get good family wage jobs that could support the community.

What we are seeing now, however, is a trend towards a permanent downsizing, particularly seen in these very large announced layoffs; and that is why I and others are very interested in exploring changes in the unemployment system, so we can look to making that system a kind of trampoline, where citizens can be at the conclusion of their unemployment self-sufficient.

I look forward to discussing these and other issues with our witnesses, and I appreciate your leadership, Mr. Chairman.

Representative Obey. Thank you.

Secretary Marshall has to leave around 2:30 to catch a plane, so I am going to ask each of the witnesses if you would summarize your statements as briefly as you can, and then we may wind up asking Committee members to direct what questions they have at him first so that he can leave and catch that plane. If we go beyond that, then we will have time for the other witnesses.

Mr. Secretary, why don't you proceed.

STATEMENT OF RAY MARSHALL, PROFESSOR, UNIVERSITY OF TEXAS, LBJ SCHOOOL OF PUBLIC AFFAIRS; AND FORMER SECRETARY OF LABOR

Mr. Marshall. Thank you, Mr. Chairman. Let me start by thanking you for inviting me to share some ideas with you on this extremely important subject. I think your presentation has put our problem in good perspective, and my remarks will be designed to enlarge on some of those comments.

I also believe that we really have a golden opportunity to make substantial improvements in our economic policy, and to put the American economy on a much sounder kind of long-run track. I, therefore, congratulate you and other members of the Committee for your work here.

I think working with the Administration and the Congress can do a lot to shape policies that will be of interest in the long run to everybody in this country, as well as in the world, because we need better economic leadership in the whole global economy now than we have had, or that we are currently receiving.

Mr. Chairman, my remarks are based on a lot of work that I have done during the 1980s. I have worked particularly with the commission known as Skills of the American Work Force and the National Center on Education and the

Economy. The National Center has developed some recommendations on human resource development for the United States, and with your permission, I would like to leave this with you.

REPRESENTATIVE OBEY. Please.

MR. MARSHALL. I didn't include it in my prepared remarks, except by way of reference. I will say some more about this document because it outlines what a group of us have been thinking pretty hard about all of our lives, but particularly during the last half of the 1980s, and that was the origin of this, the recommendations we made to President-elect Clinton. In fact, we had made many of them during the campaign.

I think one of the most important contextual understandings that we need to have is why the recovery from this recession is as anemic as it is. In addition to the policy problems, there is the fact that we are going through, in the global economy, a substantial transformation in the requirements for economic success. And that is particularly true of the United States.

If you ask yourself the question, how did the United States become the world's leading economy by about 1926—we did it very early—then I think the answer is that there were essentially three things that caused us to be in that position. One was, we had an abundance of natural resources when natural resources were much more important than they are now. Natural resources have become relatively unimportant for economic performance, and the main reason for that is that technological change really means the substitution of ideas, skills and knowledge for physical resources. And therefore, human resources have become much more important; natural resources, much less.

The second thing that we had in this country was a large internal market that made it possible to get easy improvements in productivity through economies of scale and through favorable inter-industry shifts, which raised the average level of productivity in the whole country. Scale was made possible because we had the American market to ourselves, and therefore our companies could develop scale by dividing up the American automobile market, for example, among three or four major producers.

And then the third thing is, we had supportive policies. I think it is a serious mistake to underestimate the significance of public policy in causing our economic success. These policies generally supported the growth of the mass production economy—particularly the policies during the Great Depression—but we also mass-produced students who were literate, and therefore made significant contributions to the improvement of our productivity within the framework of that kind of economic system. And we had the land grant college system and the agriculture experiment station that significantly contributed to the access of American agriculture.

Then we had the supportive policies of the 1930s and beyond, which were basically designed to keep the system going. The value of that policy was demonstrated during World War II when, in spite of most young males being in the military and the United States being an arsenal of democracy, the average American at the end of World War II was better off than when the war started. This demonstrated to the world what a strong economic system we had.

A good bit of technology that we developed during the war was used to fuel the postwar expansion and ushered in what is probably the longest period of sustained prosperity, equitably shared in our history. And I think that was an important accomplishment.

The thing that has happened, of course, is that the internationalization of the system and technological change have transformed those advantages into disadvantages. The fact that our mass-production system was so deeply entrenched meant that many of the institutions associated with it—like schools, management systems in our companies and our public policies—have become obsolete because we are now in a much more competitive, knowledge-intensive world than ever before; and therefore the conditions for economic success have changed, and the requirements of economic policy have therefore changed.

The choice we have in economic terms is pretty simple: You can either compete by reducing your wages mainly, or you can compete by improving productivity, and there are no other options. We have been competing by reducing our wages, and that is one of the reasons that we find that the only people who are better off today than they were in the early 1970s are college-educated people, and they are only 25 percent of our work force. Everybody else is worse off.

Since 1987, college-educated real incomes are declining, and the only people who are better off now than in 1987 are people with postgraduate degrees; and that process, I think, is likely to continue.

A simple fact about trying to compete with a low-wage strategy is that not only will it cause wages to be lower and more unequal, but you limit your ability to improve your incomes to working harder, and there is a limit to how hard you can work, and that is one of the reasons you get stagnation. If it were not for more women working, family incomes would have declined along with real wages, and we obviously cannot contain or sustain family income with more women working. The slowdown in the growth of the work force means that that option is no longer available to us, and therefore we will experience declining real family incomes as well as real wages, unless we get productivity up.

Now, the advantage of the productivity option is that we don't know what the limit to that is. See, we don't know what you can do, substituting ideas, skills and knowledge for physical resources. We have done a lot of work to demonstrate that that is the case. John Schultz, who works in Chicago and got the Nobel Prize for returns of physical capital, demonstrated to some of his students that we use fewer resources in agriculture now than we did in 1925, and yet we have tripled and quadrupled output, depending on the product.

How did we do that? By using ideas, skills and knowledge. And that puts you on a very steep earning and learning curve.

Peter Drucker uses an illustration that I think dramatically makes the point. He points out that the seminal product of the 1920s in the mass production system was the automobile, and the automobile was 60 percent energy and raw material and 40 percent ideas, skills, and knowledge. He is talking mainly about the Model T.

The seminal product of our day is the computer chip, and it is 2 percent energy and raw material and 98 percent ideas, skills and knowledge. And that raw material is sand, one of the most plentiful products on earth.

Now, the problem with the high productivity strategy is that it won't just happen. You have to have a strategy. We didn't have a big debate and decide to go for the low-wage strategy; we backed into it by not having a strategy. And therefore, it seems to me that we ought to try and build consensus that that is the option that we ought to try and go for. And what that means is having very different kinds of supportive policies now than the ones that we had before.

We can no longer stimulate the American economy by what we do ourselves. Therefore, we have to take a hard look at international policies and institutions. We need global stimulus right now, but that is going to require a lot of attention to those institutions.

We also need to establish a stable macroeconomic environment; and I subscribe to the views of Bob Solow and Jim Tobin—I signed on as one of the economists who supported their policies. It seems to me that in facing the immediate and long-run economic problems that we face, we ought to do things right now to increase investment, because that is the way we are going to have a higher productivity strategy, and especially investment in our people.

It seems to me that if you look at the evidence of how you are able to get a high productivity strategy, which most other countries have, first, you get supportive policies—technology policies, macroeconomic policies, financial institution policies, trade policies. But after you do that, what you do with any institution is that you pay heavy attention to the organization at work, as you have to have lean, participative management systems, and we have demonstrated that those can yield high productivity.

The second thing you need to do is to develop and use leading-edge technology. American workers will not be paid \$10, \$15 an hour doing the same work on the same machines with the same skills that you can get done in Mexico for a \$1.50 or \$2 an hour. And that means we have to have smart workers and smart machines if we are going to be a highway to China in this country, and therefore the last thing that you need to pay a lot of attention to among that group is the education and training of your workers.

Now, where we are in the United States with that is way behind. A good hypothesis about it is, how successful we are going to be depends mainly on what we do for people who don't go to college, and we do very little for them. We do more than anybody else for people that go to college, less than most other industrial countries for people who don't, and we do almost nothing to give them work-force skills. And I think that is a very important reality.

And a good, oriented hypothesis about it is, unless we pay attention to our schools, to career preparation, to what happens to education and training on the job, then we are going to be in big trouble.

The other main thing that I would emphasize about human resource development strategy is that we need to do much more for our families and children. The family is still the most important learning system. And we have a larger proportion of our children in poverty than Japan or most West European countries, and with some amazing exceptions, poor families are not very good learning systems.

The good news is there is a lot we can do to help poor families be better learning systems, for parents to be better parents and better teachers of their children; and that is probably the best way to break the intergenerational cycles of poverty that we have.

So the recommendation that we pay attention to is, we need to do things about preschool, we need to do things about school. Let me say a bit about that. Our schools were designed to mass produce literates for our farms and factories in the early part of this century, and they still do that. They do not turn out people with higher level thinking skills, and why don't they? Well, mainly because we have no standards.

One of our recommendations is that you establish standards, benchmarked to the best in the world, that all students are expected to meet. The value of standards is that, first, you create incentives for students to work hard. In our system, if you are not going to college, there is no incentive to work hard. It doesn't make a lot of difference whether you take math and science or make good grades or anything else. Having high standards would help with that.

Second, we need to provide incentives for teachers to teach in a very different way, to restructure the schools—to have high-performance schools, just like we need to have high-performance business organizations, producing enterprises. With standards, teachers know what they need to do in order to bring students up to the standards.

It also would help a lot in providing information to businesses about what the system does, and to give us some way to evaluate. We don't know how to evaluate our schools. It is almost meaningless to say that we do it by SAT scores or some pen and pencil test. A much better way to evaluate the schools would be assessment tests, like the Scout merit badges, to see what you can do; and for the process to be part of the learning process, not part of a screening process, to see what we need to do to help you meet the standards, not whether we will cause you to flunk out.

The whole process of having standards that provide incentives is a part of what we mean by high-performance organizations. Essentially, what that comes down to is, you substitute standards and incentives for rules, regulations and bureaucracies, and thereby greatly improve performance. The only way that the traditional mass-production school can improve its performance is to strengthen its weaknesses—that is, to add some rules and regulations and tests—is ultimately self-defeating.

A second thing that we recommend is that we establish high standards for people who are not going to college for noncollege occupations that are modeled after apprenticeships, combining academic and work training. That is what all of our major competitors do, and that is what we ought to do. We found that only about 8 percent of the noncollege-bound workers in this country get any kind of job preparation at all, and therefore this, I think, is the thing that requires major attention.

I think we ought to remove the financial impediments for post-secondary education. We erect stronger financial barriers than most of our major competitors in going to college. Our recommendation is that you combine educational entitlement—I would go from the GI Bill concept—but if you can't do that, then we go for a loan repaid as a surtax on your earnings, or repaid through a national service program.

Next, we need to do more for education and training of people on the job. We do a lot for people who have gone to college; almost all the expenditures are more managerial, professional and technical training. We do almost nothing for front-line workers, and the reason we don't is, the system is organized to require little of them.

When we asked American companies, do you perceive a skill shortage, only 5 percent of them said yes. And the reason is because all they need are people who are literate and will be disciplined, not people who are able to think.

We had German employers tell us they have quit selling their most sophisticated technology in the United States because American workers couldn't even learn to use that technology in a reasonable period of time. We have had people go to Japan from the United States because they couldn't find people in Texas with the education and learning skills required to use the most advanced chip-making technology. So this is a serious problem.

Related to that, we need to give companies help in restructuring for high performance. We need to have an industrial experiment station concept to give technical assistance to firms, especially small firms that are unable to do this on their own.

Finally, we need to have a labor market system in the country. We don't have it. We have a fragmented, inefficient and stigmatized system. We need to have a system of administrative boards at the federal level, at the state level, and mainly at the local level. A person in the country ought to be able to go into a local, highly computerized office and get counseling about jobs, training, financial opportunities, and that ought to be readily available to them. You can make that available in shopping centers, housing projects, and everywhere. With modern technology, there is no reason that that couldn't be done. Our competitors do that. But that requires that we establish a system, and we recommend a system. And I think that would do, Congressman Wyden, for the notion of what we need to do for the unemployed.

One of the reasons that people are unemployed is because they don't have the skills for the new jobs, they don't have the means to acquire those skills. We ought to have an adjustment program that would cause us to have an equitable sharing of the costs and benefits of change, and make it possible for people to maintain their income while they acquire new skills.

For example, in most other countries—and particularly the Scandinavias—if you are unemployed, your income continues, as it does in Germany; and if they can't find you a job, they put you in a training program to upgrade your skills so that they can maintain their competitiveness in improving productivity.

Now, how do we go about doing all that? In the human resources development plan, we recommend, through the Clinton Administration—and we would recommend it to the Congress as a way to go about it—that we ought not to mandate that all the states do all this overnight. But what we ought to do is to take a leaf out of the National Science Foundation book with their SSI program and say, we are going to give 10 grants to states to take this design and move with it, and there are some design requirements; we don't care how you do it, you figure it out. And then the next year, we are going to take another 10 grants, and the next year we are going to take another 10 grants. I think, in that process, the states could shape programs to fit their own needs.

One of the requirements you would have is that you gain control of the Employment Service and make it part of the system; separate out the unemployment insurance component of that, and let this be a labor market and education information system.

Another thing you have to do is to get some high-performance companies to agree to work with you, because it won't just happen, because these stan- dards for work need to be put together by labor, management and government working together to agree on what people need to know and to be able to do.

In conclusion, Mr. Chairman, I think it would be hard to think of a set of policies that would be more important to our future than developing a coherent human resources development strategy. Thank you.

[The prepared statement of Mr. Marshall, together with attachment, starts on p.160 of Submissions for the Record:]

REPRESENTATIVE OBEY. Thank you.

Mr. Weill, please proceed.

STATEMENT OF JAMES D. WEILL, GENERAL COUNSEL, CHILDREN'S DEFENSE FUND

MR. WEILL. Thank you, Mr. Chairman. We appreciate the opportunity to testify here today.

As you pointed out, much of the economic debate now going on in the country centers on the deficit and on the size and scope of the forthcoming stimulus package. These are certainly very important concerns. Our Nation needs to attain and sustain strong economic growth again, and getting control over the deficit is central to building and sustaining our long-term economic health. But equally central to the long-term economic health of the Nation is meeting the needs of our children and families.

As Mr. Marshall said, the economy now puts a premium on human resources. Ill-fed, undereducated, unhealthy and increasingly alienated generations of children and young adults—future workers, parents and voters—will not grow the economy, will not sustain Social Security's intergenerational promise, will not maintain a strong defense, and will not nurture our democracy, no matter how small the deficit is.

So what we have to do is to return to the human investment question, the human resource question. I agree with most of what Mr. Marshall said today, but I want to take a slightly different tack on the issue. We have to focus considerably more resources on families and children if we want a strong and competitive nation in the next century, and we have to focus those particularly on lower income families and children and on young families and children, the youngest Americans.

I will touch briefly on four points.

First is the extent of child poverty in the Nation today; second, the harms to children and to the Nation that our astronomical child poverty rates are causing; third, the particular economic problems of young families, which are driving and caused by many of these phenomena we are talking about; and fourth, what we should do about it.

First, child poverty. Children, especially very young children, are now the poorest Americans; they are almost twice as likely as adults to be poor. And more than 14 million of our children, one in five kids and one in four preschoolers, are poor. There are more poor children in America now than there are citizens in famine-stricken Somalia. There are more poor children in America today than in any year since 1965, even though our real gross national product has nearly doubled since 1965.

And, as the Committee knows, contrary to the stereotypes, the majority of this country's poor children are not black; the majority live in working families rather than in nonworking families; and a majority live outside inner cities, in small towns and rural and suburban America.

I want to make one other point about our high child poverty rates. Even if we are beginning a major and sustained economic recovery, that will certainly bring down child poverty, but it will not bring it down far enough or fast enough. In earlier eras, some children fell into poverty during recessions in this country, but larger numbers of them escaped poverty during recoveries. In the last 15 years, this pattern has reversed itself. More children are falling into poverty in each recession year than in earlier decades, and fewer children are being lifted out of poverty during each year of recovery. Therefore, a full economic cycle of recession and recovery now leaves more, rather than fewer, children in poverty at the end of the cycle.

If the pattern of the 1980s, even with its number of strong growth years, repeats itself in the 1990s, several million more children will be poor by the end of this decade than were poor at the beginning of the decade.

My second point is that the astronomical rates of child poverty we have are a tragedy not just for the children involved, but for the Nation as a whole. Poor children are far more likely to die or be disabled and far more likely to be hungry and, as a result of that, to suffer various illnesses and increased school absenteeism. They are more likely to have below-average academic skills, fall behind in school, repeat grades, and drop out. They are more likely to have babies as teens.

Poverty also means more homelessness, more substance abuse, more crime and violence, more racial tension and despair, and generally a long-term economic and social disaster, not just for children, but for the economy as a whole.

Third, much of the increase in child poverty, much of the sense among American families of growing economic insecurity, and much of the economic turmoil over the last two decades have been concentrated on America's youngest families. Young families with children, those headed by persons under the age of 30, have been devastated since 1973 by an unprecedented cycle of falling incomes, increasing family disintegration, and rising poverty.

Congressman Wyden has correctly pointed out that one of the most important questions facing the Committee is what to do about the layoffs of long-term employees hit hard by restructuring in major industries. Many of the young workers I am talking about, representing an important and different and new problem for this economy and for Congress, and a less visible one, never got a toehold in the economy at all, never got significant long-term jobs in the first place.

As a result, the total income of young families from all sources, even though many sent a second worker into the work force—the total median family income of these young families fell by one third from 1973 to 1990. In other words, in less than a generation, the Nation reduced the standard of living of those families that it should nurture the most—young families with young children—by a third, while other families basically held their own, and in the case of families without children, grew wealthier.

As a result, poverty in young families more than doubled, and by 1990 four in ten children with parents under the age of 30 were poor. Again, this poverty doesn't fit, or just fit, the stereotypes. A generation ago our young workers, if they were white or in a married-couple family, or as Mr. Marshall pointed out, were high school graduates, were fairly well insulated from poverty. But the economic damage of the last two decades for young adults has cut so broadly and deeply that now one in four children in white young families, one in five children in married-couple young families, and one in three children in young families headed by high school graduates are poor.

My fourth and most important point and the reason we are here today is that child and family poverty in America in the 1990s is not inevitable; there are things that we can do about it. Indeed, the Nation can no longer afford to have such widespread child poverty—economically, socially or morally.

The Nation now has more than adequate resources and the ability to conquer such poverty. Despite the picture that many would sketch of a Nation totally crippled by budget deficits and without resources to tackle any of its significant or fundamental problems, our income as measured by GNP will be at an all-time high in 1993. It will be double what it was a generation or a generation and a half ago, far higher than in times when we were much more confident that we could lick these problems.

The Nation's success in lifting older Americans out of poverty over the last three decades should be a model, as should be our success in the 1960s when we reduced child poverty by a half in less than a decade. We have compelling evidence from our own history that we have the knowledge and ability and resources to dramatically reduce poverty if we want to, and we also know that from the experience of other nations. Our per capita GNP is equal to or higher than that of most of our European competitors, but all of them have lower child poverty rates.

We have to make better choices, and we have to start by targeting families with children, and especially young families where the youngest and most vulnerable children are, for new and expanded benefits to give them the strong foundation they need. CDF has recommended starting with those programs that we all know work, where there is extraordinarily wide public support and a consensus that public investments can make a difference.

The first two priorities that we have this year are Head Start and immunizations. In Head Start, we seek to guarantee full funding of the Head Start program and an improved Head Start program that not only reaches all eligible children, but better meets the needs of children of working parents. If we are serious about the national goal of making all children ready for school, we have to make good on our long overdue promise to give every poor preschooler Head Start. And then, of course, we have to go on and meet the other national education goals.

The second area where we have an overwhelming consensus in this country, as a basis for action, is on a highly visible campaign to get all American children immunized. Right now, our immunization rates for preschoolers lag the rates of many Third World as well as First World nations.

We are starting with Head Start and immunization because they enjoy such wide support. They lay the groundwork for future success and focus help on the youngest and neediest children. As Mr. Marshall has pointed out, public policy has played a key role in building the U.S. economy over the past decades. One of the things we have to accomplish after the last couple of decades is to restore people's faith in the efficacy of government, in the efficacy of public policy. Head Start and immunizations are an important place to start, but it is only the starting place.

There are a range of other cost-effective ways that we can build strong families and attack child poverty, and create a work force that is able to compete in the global economy in the decades ahead.

We can insure that our children and youth grow into healthy and productive adults by including comprehensive coverage for them in any national health-care reform plan that we enact this or next year, and by moving the WIC program to full funding.

We must expand the Job Corps program, which has been extremely successful, and launch a range—as Mr. Marshall has indicated—of new apprenticeship, community service and other training efforts.

We must rescue families in crisis and bolster the self-sufficiency of both parents and children by quickly reenacting the Family Preservation Act, which was passed last year by Congress, but vetoed as part of the Urban Aid bill.

And we have to insure that parents, and especially parents who work, can support their families and lift them out of poverty. We made a start with the Family and Medical Leave Act, and now we have to move toward expanding the Earned Income Credit, toward regular adjustments in the federal minimum wage, toward stepped up child support activity and creation of a child-support assurance system, toward enactment of a refundable children's tax credit for hard-pressed, low- and middle-income families, and toward a welfare reform package that protects needy children while fixing the antifamily, antiwork attributes of our current welfare system.

If we take these steps, we can grow the economy again, and we can attack the problems that your charts showed so vividly, Mr. Chairman. These are the steps that we absolutely have to take in the years ahead. Thank you.

[The prepared statement of Mr. Weill starts on p.175 of Submissions for the Record:]

Representative Obey. Thank you.

Before I proceed with the next two witnesses, what I would like to do is to make certain that we ask Mr. Marshall a couple of questions before he has to catch the plane. I would ask that each of the Committee members limit themselves to two questions to Mr. Marshall, and then get on with the other witnesses.

Let me simply say that one of the things that bothers me—and correct me if I am wrong—is that there is a stereotype about poverty. I think an awful lot of people in this country feel that people who are poor are people who don't work. But what strikes me is, as I look around the world and see conditions in different countries, that we stand, really, in very stark contrast to most other industrial countries, at least as I read the data.

If you take a look at a country such as Germany, for instance—or most any other of our highly industrialized competitors—it is a fairly rare thing in those societies for a person to be working full time and still be poor. Whereas in our society, we have many people who are working and are still below the poverty line. And I think that that has all kinds of implications for a lot of issues, including education and training.

Let me ask you this, Mr. Marshall. You talk about the necessity to strengthen education, to strengthen training, especially on-the-job employer training. That doesn't deal as directly with the problem of people who are beyond normal school age, who lack skills to land the job that we have provided, real training in the workplace. Sunday's *Post* had an article by Spencer Rich, which took a hard look at government training programs to help those workers. It suggested that effective training programs are very expensive. The Job Corps, for instance, you remember Mr. Stockman tried to end that program because he said it wasn't cost effective. He had people do studies to prove his point. And the people that did the studies came back and said: Your point is wrong; it is one of the most cost-effective job programs. People said, oh, gee whiz, it only has a 40 or 50 percent success rate.

When you are talking about people who had zero success rate before that, it seems to me that that is quite an improvement. There is a widely publicized San Diego program for welfare recipients which raised income by 29 percent, but only from $2,200 to $2,900. You are a labor economist. You inform the Secretary of Labor. You must have researched the problem of improving skills for post-school-aged, poorly skilled people with a special focus on those workers, but not necessarily exclusively on those workers.

I desperately want to believe that if we do invest in education and training that that will work. I would like to think that I am hard headed but soft hearted when it comes to assessing whether things like that work or not. I want to believe they work, but I have seen so many job programs undertaken in the past which try to do it on the cheek, which try to provide a few weeks' training and then shove them off into the job market for training, that you know doggone well aren't adequate to meet their long-term needs, let alone their short-term.

Let me ask you—because I think it is important if we are going to go down this road with heavy emphasis on training—to make certain that this time around we do it right, that we have a realistic understanding ahead of time of what the cost is going to be per worker, and that we are prepared to meet that cost if we think it is better and cheaper than the alternative. What exactly does work, and what do we need to be prepared to spend per worker if we are going to do anything other than fool ourselves that we are really engaging the problem?

Mr. Marshall. Well, I think that is a fair assessment.

Let me say that the evidence we have accumulated came from all over the world. The Commission on Skills of the American Work Force, which I co-chaired, studied the United States and six other countries in some depth. The six other countries were Singapore, Japan, Denmark, Sweden, Germany and Ireland. And we asked the question that you are raising. We did detailed interviews in about 580 companies, 2,800 interviews; and we asked them the question about education and training, and talked to a lot of government officials.

I think we have a pretty good idea about what kind of education and training works. We know that first you have to have the basic education skills—and that is the reason we stress the standards for graduation from high school—that you need to be able to learn and to have a math background and the fundamentals.

Now, the question is: What do you do if people don't have that? Well, what we know from experience is that it is possible to have dropout recovery programs and adult education programs that can, very rapidly, bring people up to those standards. I can cite you all kinds of examples of that. I have a book on this with Mark Tucker called, *Thinking For a Living,* where we do look at the experiences that people have with this, and we know that that is what you need to do. Our recommendation is that you have those standards so that ev- erybody meets them, and not just for the people who are in school now. People who are out of school can get involved.

What would you do with dropouts, who will probably be 25 percent of the growth of our work force, during this decade? We recommend a dropout recovery program, modeled after the Job Corps Learning System, where, now, with about 28 hours' instruction, you can move people 1.4 grade levels in reading and one grade level in math. How would you pay for it? We would pay for it by having dropouts stop subsidizing the public school system. See, schools get their money on the basis of average days attended; and if somebody drops out, the money stays with the school. So you don't discourage dropout. What we would do is recommend that if a person drops out, if they have met the high standards for graduation that we would establish, they be allowed to leave the school and take their money with them to, say, a youth center that uses this technology, and which we can demonstrate all over the country is achieving remarkable success. So I don't think that we lack the means to do it or the knowledge of how to do it. We lack a system to cause it to happen.

Now, I think you are absolutely right. All of our experience suggests that good education and training is expensive in budget terms; but it also shows that if you do it right, it is standards driven and meets the other requirements for good training, that it is a high yield investment for whoever makes it. And that is one of the reasons that companies do it.

We examined a German company that spent a lot for each trainee in their apprentice program, like $9,000 or more a year for each one. They paid that out of their own pocket. And when we asked, why do you do that, they said, we have overwhelming evidence that we get back much more than we pay out. And there have been studies comparing Germany, say, with Britain and with other countries to show ... in fact, the German Economics Minister was asked, to what do you attribute the success of the German system? He said two things: One, we started late, and therefore we put a modern system in place.

I might add, we made the Germans do things we wouldn't do ourselves that helped—which I think is the irony of it. I was in Japan, and we made the Japanese do things; we taught them the system. They didn't invent that system full blown. They did what made sense in 1945 and 1946.

And, then, his second answer was, almost every young German not going to college gets into a well-structured apprentice program. They go to work, but it is a systematic training process as well. By the time young Germans are 20 years old, they are skilled crafts people. By the time they are 25, they have gone through the supervisor program, if they want to go to that; and the system is open-ended.

If you want to be a carpenter and change your mind and want to be an architect, you can do that; and you have all the requirements to do it because you met the high standards, which is what I mean by the coupling effect of standards. We waste a lot of resources in this country because we have no standards. We spend the first two years of college doing what high schools in most other countries do because we have no standards. By the time we spend those two years, people are ready for college.

If we had standards, we could bring people up to a very high level. That is the reason that we stress adult and worker on-the-job training, because if you are going to be a high performance system, you have to continue to train.

Other countries do this. We don't. That is partly because we had this kind of hierarchy called "management system," more deeply entrenched in this country than it was in most other countries. And the whole idea behind that is that workers don't have to think. Of course, that was a huge advantage, at one point, if you were trying to increase productivity with a few skilled workers and most people were just literate.

But if you are in a world today where all the workers have to have the same kinds of skills that management used to have in order to give wisdom to the machines, manage their own work, improve the quality and productivity themselves, and have a participating management system, our people can't do it. That is one of the things American employers told us as reasons we can't do what you are talking about.

One of the reasons is that all of the incentives in our system are to pursue the low-wage strategy. If you shift this work into Puerto Rico or the Caribbean basin, we get a subsidy for it. That is subsidizing a low-wage strategy. We have uncertain economic policies. In addition to that, we have people who cannot do the work, use the high level technology.

One of the most important and critical skills that you have is to be able to impose order on information, or you can't make it in the kind of world we have, because all the machines do is give us a lot of information. If you know what to do, you can use it to improve whatever you do: You can be a better Congressman; you can be a better teacher; you can run a better household; you can improve the quality of the product and solve problems.

If you don't know what to do with it, it is worse than not having it. That is one important skill. Another important skill, which our schools do not do a very good job with and most of our learning systems don't have, is to teach people how to learn. It is a surprising thing. We have learned more about learning in the last 10, 15 years than in all of our previous history. Yet, very few of our schools pay much attention to what we have learned about how people learn.

Fortunately, the model of how people learn, which is almost tailor-made, is the apprentice program. There is the combination of on-the-job learning and academic work. Now, we don't have to have everybody be in a formal apprentice program, but we think you can make that kind of technical training available to everybody and they can benefit from it.

Again, you have to have standards, because the industry people have to say, what do we want workers to know and be able to do? And we found that workers in other countries—tellers in banks, for example—can do a whole lot of things that our people cannot even come close to doing. They are financial consultants; they are in insurance, and all the rest. Our people have no ability to do those kinds of things, and therefore improve productivity.

So I think that while it will be expensive, it is a good investment. And I think it is the best investment that you can make, and we have a lot of evidence for that—international as well as here.

I think the other myth that we have to overcome about adults, as well as kids, is that some people can't learn. That is one of the things we have learned about learning. Learning is mainly due to supportive learning systems and hard work and has very little to do with genetics. Therefore, you can take these kids—I'll put a plug in for the Job Corps, because it was one of my favorite programs when I was Secretary of Labor—we found that about 25 percent of the high school graduates coming into the Job Corps were illiterate. But the system that was developed in the Job Corps made it possible, very quickly and in an interesting way, for those young people to get high school level skills and some job skills. I think that model is one that we ought to learn from and use more than we do. I think we ought to require companies—that is another one of our recommendations that is most controversial—to satisfy at least 1.5 percent of payroll for the education——

Representative Obey. That's what I wanted to get into with you. Since I believe that most of the best training is going to take place in the workplace by employers and not directly by the government, the question is how you get people to meet their responsibilities without being a free rider.

I visited a small business in my hometown in Wausau, Wisconsin last year, where a friend of mine, who runs a small business, told me that he has a policy which will pay for whatever education and training his workers want, up to and including four years of college. Up to that point, he had never lost a worker.

Now, I don't know if there are many employers who are willing to go down that road; but people say, how can somebody like that do something like that, because then somebody else can come along and hire the guy and get the benefit of it.

One of the arguments you used was against those who say we should not assess corporations a certain percentage and then rebate it to them if they meet a proper level of job training requirement.

Mr. Marshall. We had a big debate on this. As you perhaps know, I cochaired with Bill Brock the Commission on Skills of the American Work Force, and later Hillary Clinton became cochair. The Commission was unanimous on that recommendation. We looked at all the alternatives, and one of the main arguments that drove the system was, first, we see that it needs to be done. We are not going to solve the problem in the country by trying to just fix the schools. And we are not going to become competitive in international markets unless we see to it that our people are much better educated and trained than they are now.

One of our rules was that nobody recommend anything until we agreed on the facts; and when we got all the evidence in, everybody agreed to it and then said, well, how do you get it done? What economics tells us is that a rational employer will not pay any costs that they don't have to. And that is what we have done in the country. We have actually bid people away from other countries; but now that our wages are no longer the highest in the world, we are going to have trouble with that. Companies bid away from other companies, and we have to find some way to eliminate the free ride. At any rate, it seemed to us that the most painless way to do it would be to spend at least 1 percent. During the campaign, President Clinton said 1.5 percent. I think the majority of our Commission would have supported 1.5 percent. But now I know that you would get some political opposition to this.

So my recommendation is to turn to the business community, if they don't like this, and say, you see the problem; what would you do? That is what the Germans did. One of the reasons the Germans pay for all this themselves, first the experience forced them to see that it was a high-yield investment, and therefore a good thing to do; but, second, if we don't do it, the government will make us do it.

Well, if we had some way to cause American businesses to avoid this free rider problem, what we would do is not just use that money for education and training. The Swedes have what they call renewable funds, which makes some sense. That is, use it to help pay for this extension service idea that helps small business with their education and training programs. It seems to me, if they are going to benefit from people being well trained and well educated, then we have a right to expect them to help pay some of the costs of doing it. Other countries do this. There are various ways you can arrange it. We like the so-called levied grant system. You don't pay it unless you do it.

We found, on average, companies already spend about 1.4 percent. We did the work. So you weren't calling on people to do a lot, you know, that wasn't already being done, and if you had some standards for it—which is the other reason to keep stressing the standards—I wouldn't let them just do whatever they wanted to do. They have to be moving towards some standards. Then they get back, I think, more than they paid. They might not believe that up front, but I believe they would in the end.

All the evidence suggests that that is, in fact, the case. One of the reasons the Germans turned to the system that they now have is that they looked at the evidence from our GI Bill, which showed that the Federal Government got back from the World War II GI bill a substantial return above what it cost them. If that is the case, if the returns are as large as is suggested by that evidence, then you lose a lot not making that investment; and that is the conclusion they came to. I think that is one of the reasons they really believe what we say we believe. They believe their people are the most important asset. We say that, but we sure don't act like we believe it; or we wouldn't treat children the way we treat them in this country.

The German employers have a concept that they call "social market economy." We have to be responsible for them, investing in our people and preventing poverty, giving health care to people, immunization and training. That doesn't cost us anything. It only costs you something if your mindset is for the low-wage development strategy. Then you see it as a cost and not as an investment.

Representative Obey. Thank you very much.

Senator Sarbanes.

Senator Sarbanes. Thank very much. I was wanting to ride along with this discussion.

Do you think there is a significant difference between the training provided by the public sector and training obtained in the private sector by the employer?

Mr. Marshall. Yes.

Senator Sarbanes. Suppose you said, well, we are going to do the training through the public sector, as opposed to having each employer do on-the-job training. Is there a significant difference in achievement?

Mr. Marshall. I think that it ought to be a combination, if you are talking about job training. That is, there ought to be a partnership between the public and private sector. The private sector knows what kind of people they want. They ought to help set the standards.

There are some things you can do better in a classroom setting, whoever runs it; and other things you can do better in a job setting. It is hard, in most classroom settings, to reproduce the workplace. Therefore, the workplace is a good place to learn those things. You also get motivation because people can see what they need. That is one of the things we have learned about learning, and it seems to me to be less the question of whether it is public or private.

I don't believe, for example, with respect to schools, that there is any credible evidence that private schools are better than public schools. We deal with that in *Thinking for a Living*, as well. Once you look at all the evidence, you don't see that. I think what you do is a lot more important than whether it is public or private. And I think that's a legitimate role for the public sector to set.

I would say that one important public function is to create incentives for companies to do what is in their interest and in the national interest. Evidence suggests that they won't automatically do what is in their long-run interest if they have a short-run orientation.

SENATOR SARBANES. That is what I want to pursue, because the next question I want to ask is, is there a big difference between large employers and small employers?

MR. MARSHALL. Yes. Almost all of it is done by large employers, except in industries like construction.

SENATOR SARBANES. Here is what the employers, who are not doing it, say: If you throw this burden on us, it is the burden that will break our backs. We are close to the margin, but it is a worthwhile goal; it is a laudable goal; we agree with that. But we just can't find the wherewithal with which to do it. We are right at the margin and if you require that of us, we can't handle it. That is one argument we get. I would like to know your answer to that.

The other argument—which I am not exactly clear on how you are going to get at it, particularly if you give any credibility to the point I just made—is how you avoid the cherry picking for some, where some employer does all of this stuff, and then somebody else comes along and he bids away his employee. Not having had to incur the cost, he can offer him a somewhat better employment package. So they find this person they have invested in and trained, who goes marching off somewhere else, gets a short-run windfall.

MR. MARSHALL. I think that is a problem, which is one of the reasons we recommend the levied grant project, that everybody has to pay, not just people who are doing the training.

SENATOR SARBANES. In order to do that, how do you get over the first problem that I indicated to you?

MR. MARSHALL. My view about that is that it is probably exaggerated. If you were at the margin and the only way you can operate is to raid workers away from other companies, my view is, you ought to go broke and cave in. What the society ought to do is to try and take those workers during an adjustment program and shift them into a company that can pay for the education and training of their front-line workers, and therefore be world class.

The reason I say that, if you don't make companies cover costs, you are subsidizing inefficiency. An efficient firm is the one that can operate by paying all of the legitimate costs—including environmental, worker training, worker standards—and make a profit. If they are unable to do that, it seems to me we ought to discourage them.

SENATOR SARBANES. Do you think we have an attitude problem that complicates this, compared to other countries; namely, the objective is to go to college.

As you pointed out, only 25 percent, roughly, of our people go on to college. We have 75 percent who are not doing that, and yet we failed to attach any status or premium to developing high skills and high wages, which are achievable even without an actual formal college education—

Mr. Marshall. I think there is no doubt at all that we are among the most elitist people among the industrialized countries in our attitudes about workers. It comes from Taylorism. That is what the management system taught us, that only college-educated people could understand the science of work.

The status of a skilled worker in Germany or Japan is substantially higher than it is here, and they value that. And one of the ways that they eliminate the distinction is they make the apprentice open-ended. That is, if you make the requirements, if you go through the apprentice program, you can go to the university if you want. And there is no reason why we don't do that, but you have to have the standards. You have to have the learning and thinking skills to go on and do that. And the same thing with, I think, the attitude of management when they allocate the training within the company. They are likely to spend it mainly on managerial and professional training.

Senator Sarbanes. We don't have it here, but we have a chart we use on this Committee which shows, compared with the Japanese, how much they put into training their employees and how much we do; and there is a gap at every level. But we are closest in training college-educated people. We are still less than them, but we come closer. As you move back from the college educated, the gap grows very significantly, and our companies do far less for the less than college-educated people, in terms of their own training programs, than the Japanese do. Ours is very heavily loaded to the more highly educated part of a company's work force.

Mr. Marshall. That is right. Of course, one of the big differences between what employers told us is that most employers in other countries, even though they had high standards and better educated front-line workers—said they perceived a skill shortage. Very few American employers said they saw a skill shortage. Bill Brock said that is the good news and the bad news. The good news is that the schools can turn out the kind of people they want. The bad news is that they plan to keep on competing for the mass production, low-wage strategy, and therefore are not likely to restructure. And I think unless we cause it to change, they are not likely to.

Senator Sarbanes. Thank you very much, Mr. Chairman.

Representative Obey. Congressman Wyden.

Representative Wyden. Thank you, Mr. Chairman.

Mr. Marshall, you make so many good points. I particularly like your analysis that puts a special focus on the difference between the skilled worker and the unskilled worker, and the challenges we are going to have in that regard.

Let me ask you first about the unemployment system. One worker described it to me as, essentially, being economic methadone for him. He said they gave me my check; I get it on a weekly basis; but I won't get anything out of this program until I can eventually get out on my own.

My sense is, with this downsizing that you and others have talked about, we are now going to be turning out more individuals from these large companies who honed skills over a period of 15, 20 years, who could go out and use those self-employment programs. So the unemployment program could, in effect, become a trampoline, so at the end of it they could get out and be self-sufficient.

Is it your sense that in the downsizing of the people who are being permanently laid off, we are now going to have more of those individuals with real skills and creative abilities, who could use this unemployment system in a new way?

Mr. Marshall. I think that is right. And I think we ought to learn from logic, as well as what some of our competitors do.

If you were in Sweden or Germany, for example—Sweden especially—the last thing they would do for you if you were unemployed is just pay you the dough. They call it unemployment compensation.

First thing they do is to assess your skills through one of these offices that I think we ought to have, and then they would say, well, we have a job for you someplace, and they would help you go and find out about that job. Or they would say, look, if you want to keep on earning the income you have been earning, you are going to have to get some more skills. You have a good bundle of skills, and they are not hard to identify in a set, but you need to get these others. We have a program you can get into, and here is how you pay for it. We will maintain your income maintenance if you will get into that program, but if all you are going to do is just draw unemployment compensation, you are off the dole. Some people would say that is harsh; nevertheless, it is an effective way to do it.

Now, it seems to me that with our modern information technology, if we organize a system effectively, we could tailor a program for the individual worker. I would do that. I would have the employment service spend a lot less time through this amiable fixation we have, that people are looking for work, which encourages fraud. The assumption is that we are dealing with cyclical downturns. In American industry, we use the unemployment compensation system as a wage substitution as a way to retain our work force during the downturns. Everybody thought they were going back when the cycle picked up, so they didn't really look for another job in some other place.

Now, I think that is not our main problem. Our main problem is to continue to see that people have the skills, information, to be able to move into jobs that are available if you have the skills, get a better match between the skills and the jobs. And I think we ought to do that and we can do that.

Representative Wyden. I want to ask you another question, but I also want to tell you, I very much appreciate the approach you take by trying to take a block of states at a time to do this. The self-employment law, which I authored, has expired. We are going to extend it now, but the success that we saw in Massachusetts and Washington ought to be extended to other states. And your idea of trying to go to a block of states at a time makes sense.

Mr. Marshall. I agree with that. I didn't comment, but I think the big thing is not a job; it should be a career and an income-earning opportunity.

Representative Wyden. Let me see if I can get one other question in real quick. I know you have to get a plane.

You talk about the challenge in terms of the global economy—and it is one that I have heard Senator Sarbanes talk eloquently about, as well—we are probably going to be faced with the North American Free Trade Agreement, the next concrete case of exactly what kinds of approaches we ought to use in terms of labor, training, and the like.

Could you capsulize on a couple of the ideas that you would think would make sense for the agreement that President Clinton has perceived.

Mr. Marshall. I think the guiding principle ought to be to encourage both the United States and Mexico to pursue a high-wage strategy.

Now high wages doesn't mean Mexican wages equal ours. It means that your objective is to maintain and improve your income. And that is a high-wage strategy.

The alternative, which is what the North American Free Trade Agreement is designed to do now without the side agreements, is that you don't try to narrow the gap by raising Mexican standards; you try to narrow the gap by lowering U.S. and Canadian standards. And I think that would be a huge mistake to try and do that.

The European Community has taken the opposite view. They are trying to bring the Greek, Portuguese and Spanish wages up to the German level. Now, you don't do that overnight. So I think that is the first thing, is what the guiding principle ought to be. And I believe that would do more to improve relationships between countries than almost anything you can think of.

The wage competition is what the "begger thy neighbor policy" was during the 1930s. It will generate friction between countries. Everybody pursuing the high-wage strategy will adopt it. Nobody is going to get mad at Mexico for improving the productivity of their people and improving their education and training of their people. But we are going to get mad if American companies try and escape to Mexico in order to avoid meeting legitimate labor standards and environmental conditions in this country.

I think the labor and environmental standards—and I have spelled that out, and would be glad to share with you a paper I have done on that subject—will encourage efficiency, mainly because you cause people to compete by improving productivity and efficiency, not by reducing labor standards.

Then we need to, I think, do some things called a multinational basis to help Mexico with technical assistance if that is the case, or for them to help us. In some cases, their standards are higher than ours on paper. They don't enforce them, but on paper they have some pretty good standards.

I think you can get into a big argument about whether you are going to create jobs in the United States or cost jobs. Nobody thinks it will create many, not even the most optimistic proponents of the NAFTA believe that. It is marginal at best. And I believe you will have substantial displacement and loss of jobs, and that it will contribute to a widening of the income gaps in the United States. It will perpetuate that process. But since we don't know, why don't we erect some safeguards? Why don't we see to it that the agreement is really in the best interest of the United States and Mexico? It is in our interest for Mexican workers to improve their conditions. It is in our interest for Mexico to develop a stable, democratic and prosperous system. They are not likely to do that, in my judgment, without some external help. It won't automatically come from the NAFTA. I am convinced of that, and the market won't do it, and didn't do it for us. We didn't pass OSHA until 1970, and we had been developing a long time before that took place, so I think that we need to erect the safeguards, try to see to it that that agreement is mutually beneficial as the proponents claim. I don't believe it will be without strong environmental standards.

Representative Obey. Thank you, Mr. Secretary. I know you have to leave.

MR. MARSHALL. Thank you, Mr. Chairman.

REPRESENTATIVE OBEY. I appreciate you coming.

I apologize to the other two members of the panel, Mr. Shapiro and Mr. Vedder, for the bifurcated nature of this hearing, but now that Ray is on his way, why don't we continue with Mr. Shapiro.

STATEMENT OF ISAAC SHAPIRO, EXECUTIVE DIRECTOR, CENTER FOR BUDGET AND POLICY PRIORITIES

MR. SHAPIRO. Thank you. I actually did have to restrain myself from jumping in right after your first question to Mr. Marshall, because it is the topic of the working poor that my comments will specifically address. My statement is based largely on a forthcoming report on the working poor that I am co-authoring with Bob Greenstein, the Center's executive director.

Investments in education and training will fully pay off only if improvements are also made in the returns to work for low-wage employees. The wages of the typical nonmanagement worker, as you noted, have been falling for some time, and the problems of the working poor have been rising. A better prepared work force can help reverse these trends, but direct steps to reduce wages are needed as well. I will focus my remarks on two such steps, increases in the Earned Income Tax Credit and minimum wage.

The problem of eroding wages is particularly acute for low-wage workers. A recent Census Bureau report found that between 1979 and 1990 the proportion of full-time, year-round workers who were paid wages too low to lift a family of four to the poverty line increased dramatically. Of note, the report found that the proportion of workers with low earnings rose about two-thirds for workers of all educational backgrounds. This underscores how better training and education will not by themselves address the wage problem and, indeed, as you noted, Mr. Chairman, how the working poor remain a disturbing social problem.

In 1991, an estimated 20 million people, 56 percent of the poor, lived in households where someone worked during the year. An even larger share of poor families with children include a worker. Indeed, 5.5 million people live in poor families with children, which includes a member who worked full time, year-round.

To address the problems of the working poor, there has been growing support for the goal that work should pay sufficiently so that if you work full time, you should not be poor. President Clinton is among those who have expressed emphatic support for this goal.

The reform agenda for achieving this goal is wide ranging, but two of the most important policies are the Earned Income Tax Credit and the minimum wage. The refundable Earned Income Tax Credit is strongly pro-family and strongly pro-work. It is provided only to low-income parents who work and live with their children.

Moreover, EIC benefits increase with each additional dollar earned by the very poor. Consequently, the EIC strengthens the incentive to work for those working little or not at all. To obtain these benefits, families simply must file income tax returns. The Earned Income Tax Credit was expanded sharply in 1990. This expansion will take full effect in 1994. In that year, the maximum basic credit will be $2,000.

The minimum wage, in contrast, fared poorly during the 1980s. It remained at $3.35 an hour, from January 1981 through March 1990, when legislation raised the wage floor in two steps to its current level of $4.25 an hour. These increases made up less than half of the ground lost to inflation during the 1980s. In fact, if the value of the minimum wage were to have the same purchasing power today as it averaged in the 1970s, it would need to be $5.42 per hour.

In addition, in the 1960s and 1970s, full-time work at the minimum wage usually lifted a family of three above the poverty line. By contrast, in 1993, full-time minimum wage earnings will leave a family of three 23 percent below the poverty line. In fact, the minimum wage is now so low that a family of three, with a full-time minimum-wage worker, remains below the poverty line even when the EIC benefits are added in. Full-time minimum wage earnings plus the EIC benefits minus payroll taxes leave a family of three $1800 below the poverty line. Since the poverty line rises with family size, the net income of a full-time minimum wage worker falls $5,100 below the poverty line for a family of four.

If the combination of minimum wage earnings plus the Earned Income Tax Credit is to lift families out of poverty, these policies clearly need to be strengthened. Moreover, it is imperative that policy reforms not rely too heavily on one policy instead of the other.

The two policies are best viewed as complementary approaches for several reasons. The first reason is that the cost of the EIC expansion necessary to meet the goal that families with full-time workers escape poverty is exceptionally sensitive to the value of minimum wage. Without some increase in the minimum wage, the cost of the EIC expansion to the government is likely to be several billion dollars larger. The cost of the minimum wage expansion is borne by the private rather than the public sector.

The targeting of the proposals also complement each other. The EIC is better targeted to the working poor families. At the same time, however, minimum wage benefits poor, single individuals and childless couples, while the EIC does not.

In addition, most poor workers do have earnings at or near the minimum wage. Relying solely on expansion in the Earned Income Tax Credit is also unwise because it would further increase the already high marginal tax rates in the income range over which the EIC is phased down. Since the minimum wage does not phase down as income rises, a higher minimum wage does not raise marginal tax rates.

Finally, virtually all EIC recipients receive the credit in one annual lump sum payment, while the minimum wage is delivered in every paycheck.

In short, the EIC is better targeted, while the minimum wage delivers its benefits on a more timely basis without raising marginal tax rates. If the EIC is relied upon too heavily, the public costs are likely to be very high, but a combination approach results in the sharing of costs between the public and private sectors.

While expanding the EIC has received widespread, bipartisan support in policy circles, expansions to a minimum wage have proven more controversial. The potential effect of a minimum wage increase on employment has, of course, been the principal argument raised in opposition to such an increase. The argument is made that a higher minimum wage would price a large number of young workers out of the labor market. While the potential employment effects of a minimum wage increase do deserve consideration, the weight of the empirical evidence suggests the effects are likely to be modest.

One recent analysis updated the single best study of the effects of the minimum wage during the 1960s and the 1970s. The new study used information through 1986. The update found the minimum wage has a very modest effect on teenage employment. It also found that there was no significant relationship between the level of the minimum wage and the level of employment of young adults or older adults.

Moreover, studies by some of the Nation's leading labor economists of the impact of increases in the minimum wage in 1990 and 1991 have found it did not reduce employment.

David Card of Princeton University examined the effects of the minimum wage increases on states with differing proportions of low-wage workers. He found that the wage increases boosted incomes, but did not negatively affect employment, even among teenagers.

Another notable study of the impact of the recent increases in the minimum wage was conducted by Larry Katz and Alan Krueger. Their findings were similar to Card's. They also found that the minimum wage increase had no effect on inflation.

These studies do not suggest that any increase in the minimum wage, no matter how large, would have only desirable effects, but they do suggest that when the minimum wage is set at especially low levels, as it is today, the employment effects of a change in the minimum wage may be modest.

How should the EIC and minimum wage reforms be structured? To strengthen the Earned Income Credit, one necessary step is to adjust it more adequately by family size.

The EIC now has two tiers, a basic benefit for a family with one child and a benefit about $160 a year higher for a family with two or more children. The $160 annual increment is far smaller than the increased income needed for an additional child. A restructured EIC could include a third tier of benefits for families with three or more children.

As far as changes to the minimum wage, the *Wall Street Journal* recently reported that:

> Labor Department officials are expected to push for an increase of as much as 10 percent in the minimum wage and then index it to inflation.

The article then went on to describe how business groups are gearing up to oppose this presumably large increase in the minimum wage. The article did not include any context in which to judge the resulting value of minimum wage. It turns out that an increase in the minimum wage of 10 percent would simply return its purchasing power to that achieved on April 1, 1991, when the minimum wage was last raised. This was the value agreed to by President Bush. He vetoed a higher level.

More importantly, even with the 10 percent increase, the minimum wage would remain well below its traditional level of support. Its purchasing power would remain 16 percent below its average during the 1970s. If the minimum wage is to be restored to a level closer to its historic value and in order to get closer to the goal that all families with full-time workers should not be poor, a real increase of more than 10 percent is appropriate.

Such an increase should be spread out over several years in order to ease labor market adjustments. The first increase should also be moderate enough that it does not interfere with an economic recovery. Once the target level is achieved, indexing the minimum wage would allow for small, steady changes that labor markets should be able to absorb.

In a final note, I would like to discuss one particularly important investment in children, and that is the need to fully fund the special supplemental food program for women, infants and children. A recent study by the General Accounting Office found that each dollar invested in prenatal WIC benefits saves nearly $3 in costs within the first year after birth, and even more down the road.

The payoff for WIC funding is the main reason why the program receives strong support among key business leaders, among both Republicans and Democrats in Congress, and by President Clinton. It has also led to widespread support for fully funding of this program so that it can serve everyone who is potentially eligible for it. Expediting the full funding of WIC merits consideration in the economic stimulus package.

The program has an exceptionally high spend-out rate, meaning that an additional dollar spent on the program will put money into the economy quickly. The desired long-term expansion of WIC could simply be front-end loaded at no additional long-term cost.

Thank you.

[The prepared statement of Mr. Shapiro starts on p.183 of Submissions for the Record:]

Representative Obey. Thank you.

Mr. Vedder, please proceed.

STATEMENT OF RICHARD VEDDER, PROFESSOR OF ECONOMICS, OHIO UNIVERSITY

Mr. Vedder. Thank you, Chairman Obey, for inviting me.

There has been a great deal of similarity in the comments made today. Let me, in the interest of diversity, offer a different perspective on some of these issues, although I would say that I do agree with Secretary Marshall and some of the others on the importance of productivity, on the needs for standards with respect to education and other things.

First, let me speak briefly about job opportunities. What can be done to reduce unemployment?

I am an economic historian who, with my colleague, Lowell Gallaway, has recently written a book, *Out of Work: Unemployment and Government in Twentieth-Century America,* which was published by the Independent Institute. Our examination of 90 years of American employment history suggests that jobs are created in greater numbers when market forces are allowed to operate without substantial governmental interference.

Moreover, the greatest periods of high unemployment in American history were largely attributable to well-intended interventions in the labor market that led to wages for workers being pushed above a equilibrium level consistent with full employment.

Labor will be hired when the price is right. Like virtually anything else, more labor is hired when it becomes cheaper.

The law of demand works in labor markets just as it works in the potato market. Any government effort that tends to increase the cost of labor will tend to reduce job opportunities for American citizens.

For the past several months, what Gallaway and I call the adjusted real wage has been falling. Moderate wage settlements, combined with rising labor productivity, have reduced labor costs per dollar of sales, which is beginning to lead to greater demand for workers.

Since June, the unemployment rate has fallen at least one fourth of the way back to its long-run sustainable rate, and my reading of the statistics on wages, prices and productivity leads me to believe that the unemployment rate will be down to 6.5 percent by this summer without any intervention. Thus, without any special governmental policy, unemployment will have fallen about one half of the way back to normal, from its recessionary high in a period of about a year.

I am somewhat concerned, however, that the recovery could be disturbed by well-intended policies that tend to raise labor costs and thus lead to reductions in employment. It has been mentioned that Labor Secretary Reich is on record for favoring increases in the minimum wage, including changing wages in the economy.

I would suggest that the sharp increase in the minimum wage in 1990 and 1991 contributed importantly to the rise in the adjusted real wage at that time, which brought on the 1990 recession. The tragedy of minimum wage intervention is that the burden of unemployment that is generated falls largely on the young, the unskilled, and members of minority groups. The burden falls on those least able to afford it.

Other proposals, discussed during the campaign or since, would have similar negative effects. Banning the hiring of replacement workers in strike situations reinforces wage rigidities and collective bargaining agreements that they impose—rigidities that tend to prevent markets from alleviating joblessness. A training tax to finance worker training likewise would increase labor costs per dollar of sales, leading employers to reduce hiring.

Extending unemployment insurance benefits further, already at a historic high with respect to duration, would raise what economists call the reservation wage, reducing job growth in months ahead. Similarly, proposed increases in the taxes on income would reduce the quantity of labor supply.

I think it is no accident that the creation of 5,000 jobs a day during the 1980s occurred after the time when changes in the tax code increased the spirit of enterprise in the work efforts of Americans. A similar job boom followed the enactment of John F. Kennedy's tax cut in the 1960s.

Most jobs are generated by small business, and the boom in jobs in the mid-1980s can be attributed in part to a favorable regulatory environment towards small business, while the sluggish job growth during the last several years can be at least partially explained by an increase in per-worker burden associated with public policy.

The Clinton Administration would be well served to reverse the anti-small business bias of the Bush years, returning to the environment of the Reagan era, which provided a regulatory and tax setting conducive to the hiring of labor.

The twin goals of high living standards and substantial job opportunities for American workers are incompatible objectives unless the productivity of labor rises. That is something nearly all of us, I think, agree on. High wages price workers out of markets, so getting rising wages and more employment requires output per worker to rise. President Clinton seems aware of this imperative.

Two likely planks in the Clinton economic program are infrastructure construction and job training programs. Infrastructure investment should be made based on its expected rate of return to society. Public works programs to augment employment simply do not seem to be effective, based on history.

Five years into the New Deal, for example, and eight years into the Great Depression, massive public works expenditures had left the Nation with an unemployment rate approaching 20 percent, with a modest improvement from the depression trough being explained by productivity growth in the private-sector. Federal spending crowds out private-sector spending, and there is some evidence that a shift of resources to public uses causes a drag on labor productivity.

That aside, public works projects take a long time to implement, at least a year, and by the time infrastructure spending comes on line, the unemployment problem will be eliminated.

Finally, how can a nation be serious about deficit reduction if it is introducing new spending programs?

Regarding job training, the evidence with respect to federal job training programs is not particularly reassuring. With respect to public education, there are more than 100 scholarly studies showing no relationship between spending and student achievement.

Without substantial changes in the delivery system for education, spending in this area is likely to be counterproductive. More important, however, there is decisive evidence that the most important variable in improving labor productivity is work experience.

Male high school graduates, who are full-time workers working year- round, average less than $16,600 a year in 1991 if they were 18 to 24 years old, but more than $32,000 a year if they were 45 to 49 years old.

Assuming workers are roughly paid according to productivity, the more experienced workers seem to be roughly twice as productive as the relatively inexperienced ones. The earnings gains for women tended to be somewhat less, but are still substantial. Yet public policy has failed miserably in getting persons to take that critical first job and stick with it. This is particularly true of the disadvantaged and racial minorities.

In the year of Brown vs. Board of Education, at the very beginning of the civil rights movement, 58 percent of nonwhite Americans of working age had jobs. In 1992, the proportion was less, under 56 percent. By contrast, for whites, the proportion working increased dramatically over time, from about 55 to 62 percent.

In 1954, nonwhites outworked whites, while today the reverse is true. This is so despite a myriad of civil rights laws designed to reduce racial discrimination.

Why has this happened?

I would argue that federal programs designed to help low-income Americans disproportionately affect minorities. These programs have reduced the work ethic among the poor relative to the nonpoor.

The true marginal tax rate on work income for black Americans is probably, on average, much higher than it is for whites simply because of the insidious effects of public assistance programs.

A young black teenage girl with a baby, considering taking welfare or a $6 an hour job, will usually take welfare since the welfare benefit package is worth as much as work income. There is effectively a 100-percent tax on work.

The white male graduating from college in engineering, however, will take a $30,000 a year job over a $12,000 welfare alternative. Our public policies discourage work efforts among the minorities, preventing them from taking the first step up the job training ladder towards more productive employment.

Thus, public policy has robbed the Nation of productive resources; we have prevented some of our citizens from taking low-paying jobs that lead to the experience and productivity gains that ultimately result in more remunerative employment. Median black family income has declined relative to white income since 1967, despite narrowing pay differentials in comparable employment, simply because of declining labor force participation among blacks, which I think results, in large part, from public policy.

In short, public policy has deterred productivity growth, has promoted unemployment, and has been regressive in the most fundamental meaning of that word. Instead of re-creating old programs that have failed in the past, I would hope that the Clinton Administration look to new market-based solutions to our problems of unemployment and inadequate productivity growth.

Thank you very much.

[The prepared statement of Mr. Vedder starts on p.191 of Submissions for the Record:]

Representative Obey. Thank you everyone.

Mr. Vedder, I am not sure where to begin. I think I am going to begin with a quote from Mr. Weill's paper.

He said:

> I believe that the American people feel that with the high production at which we are now capable, there is enough left over to prevent extreme hardship and maintain a minimum standard floor under subsistence, education, medical care and housing to give all a minimum standard of decent living and to all children a fair opportunity to get a start in life.

That statement was not uttered by George McGovern or Bill Clinton or any other left-wing radical; it was said by Bob Taft, which explains why, when I was a freshman in high school in 1952, I distributed literature to one-third of the households in my hometown for Bob Taft. It was at that time, when I thought I was a Republican—I always kid my Republican friends about this— that I learned how to read, and changed parties. But I really did think that Bob Taft was an intelligent conservative, who understood that the purpose of economic policy was to effect human conditions. And I think, frankly, that Bob Taft's intelligent and constructive conservatism has been taken over these days by a strain of ideological conservatism which separates theory from human impact.

Frankly, I think a couple of points that you make in your statement, while they are certainly interesting on a theoretical basis, they don't hold up when you take a look at the real world.

For example, and I would ask Mr. Marshall and Mr. Weill to respond to this, as well. You indicate your opposition to raising the minimum wage, that the increase in the minimum wage in 1980 had a very negative effect on the economy. I would say that if you take a look at the chart, which Mr. Shapiro submitted in his testimony, it shows, relative to the poverty line—and if I am misreading this, please correct me, Mr. Shapiro—that the minimum wage declined in purchasing power relative to the poverty line by more than 30 percent between 1978 and 1990; that the action taken by the Congress to raise the minimum wage, after we endured, I believe, at least, one presidential veto, that that bill simply reduced the gap between the poverty line and the effective minimum wage by one third. It seems to me that hardly had a dramatic effect on the economy.

I would also submit that I find it quaint that we have people from a wide variety of sectors in the economy coming in defending the principle of indexation of income tax rates, promoting the idea of indexing depreciation, and yet opposing the idea of indexing the minimum wage.

We have all kinds of people in this society whose wages are indexed in one way, shape or form. Senior citizens under Social Security, and a lot of federal employees' wages, except the very highest paid ones, are indexed. Why shouldn't we, as a simple matter of equity, at least, index the minimum wage that goes to the least advantaged people in this society?

Mr. Vedder. Well, you have made several points. The first one you made, I must say, I was somewhat amused by it, because I went just the opposite way. I voted for Lyndon Johnson in 1964, and as I read the evidence and so forth of the 1960s and 1970s, I changed my political perspective in somewhat of a different form than you did, Congressman.

Representative Obey. One of us was very wrong.

Mr. Vedder. Well, my grandfather was chairman of your political party in the state next door to you for 12 years. So I come from a background that has always considered itself very compassionate and very interested in dealing with the poor and with those people who are disadvantaged.

I think what we are really discussing are our differences in approaches of dealing with those problems, rather than one of different motives.

With respect to the minimum wage, there is a variety of different evidence relating to its effects on the economy. There are equity issues, but the equity issues are sometimes more complex than perhaps your statement has made it, I think.

For example, in the second quarter of 1990—and this is from the *Economic indicator*, which your Committee apparently put out—the average compensation per worker in the business sector of the economy rose 8 percent on an annual basis. This is after years of wages moving up 3 or 4 percent a year.

That explosion in wages in that single quarter, I think, probably was at least partially explained, if not totally explained, by the increase in the minimum wage of 13 percent on the first day of that quarter.

Now, I think that that had something to do with pricing labor out of the market, something to do with the increase in unemployment that occurred over the next year.

Representative Obey. What empirical evidence do you have for that hunch?

Mr. Vedder. I have just finished a book, Representative, which I have been working on, on and off, for 18 years, in which I looked at the relationship between wages and employment and wages and unemployment. There is a very striking, strong statistical correlation, which has actually shown in one of the graphs in the full statement that I presented. When you see a pushup in wages, such as we had in 1990, and also a secondary effect in 1991, when in the second quarter of that year the average compensation increase was 5.6 percent, which is again well above the long-run sustainable average; when I look at the historical record on the relationship between wages and employment, and I look at what are seeming effects of the 1990 and 1991 increases, certainly there are aberrations in the data, in terms of increases in wages in the very quarter in which these minimum-wage increases are going in. When I see that, I say the two are related. And the tragedy to me is that the burden of that falls on the people who are least capable of sustaining the damage. It falls on minorities; it falls on low-skilled workers; it falls on teenagers.

Representative Obey. Mr. Vedder, I would simply say that that is an interesting theory, but I don't think you have cited any empirical evidence to back it up.

Mr. Vedder. Well, I would be glad to get you——

Representative Obey. Since we are going to be spitting off our theories, Mr. Shapiro, I know you wanted to comment, I will call on you in a minute. But first, I want to express my view about how the 1990 recession began.

Mr. Vedder. Sure.

Representative Obey. In my view, what happened is that the economy was being sustained for a long time, because people were spending a very large percentage of their income and saving very little, and in the short-term that was sustaining consumer demand. And then I think we had a political act which shook the confidence of consumers all over the country. I think we had the decision by President Bush, after the Congress, rightfully, in October 1990—in my view, this is one of the few times that Mr. Gingrich and I agree, but we agreed for opposite reasons—turned down the budget summit agreement.

This budget summit agreement called, among other things, for tax increases. But the tax increases that it called for, for people between $20,000 and and $50,000 incomes, were twice as large as the tax increases called for on the part of people above $200,000. That is the reason that I helped organize the Democratic opposition to that summit, and that was brought down.

At that point, the President had two choices. He could have chosen to sign a continuing resolution and keep government going, and try to work out another compromise not only with us, but with the right wing of his own party, or he could have chosen to do what he did—which is to say, he is going to stop government by vetoing the continuing resolution, shutting down the Washington monument, and telling the country that, in effect, the government was out of control.

I deeply believe that that act, when he decided to do the latter, took the confidence right out of the country. I think consumers took a look at that and said, "My God, it is bad enough that families are being squeezed. It is bad enough that we are in debt up to our ears. It is bad enough that the government is in debt up to its ears, but now the political system is even out of control." And I think that really shook them. And I think that made it much easier for their attention to be focused on the real problems in this economy. I think that substantially weakened consumer demand, and people simply quit buying because they were scared. And I think that is primarily what brought on that recession.

Now, I don't have any more empirical evidence to back up my theory than you have to back up yours, in my view.

Mr. Vedder. Well, I would argue that I have 338 pages of empirical evidence in my book, which isn't specific to the 1990, 1991 recession, but it is specific to a long-term historical pattern of behavior.

Representative Obey. Well, I will get to that historical pattern in a moment, because I have two other questions I want to ask you.

Mr. Vedder. Sure.

Representative Obey. I just have to say that I think you have to do better than to blame a tiny increase for the lowest paid workers in this society for the collapse of consumer confidence and tossing the economy into the dumpster. I frankly think your theory is farfetched.

Mr. Vedder. Well, you recall, that is your theory, not mine, about pushing the economy's confidence down with regards to the minimum wage.

Representative Obey. I understand.

Mr. Vedder. I do think, by the way, that there is some substance to what you said regarding confidence. I don't think confidence was very high in 1991, either. Just so that I am not misquoted, I did not suggest that raising the minimum wage led to a decline in confidence, and that that was the reason.

Representative Obey. I understand. But you did indicate that it had a substantial impact on causing the recession in 1990, and I respectfully disagree with that.

Mr. Vedder. Sure.

Representative Obey. Mr. Shapiro, I know you wanted to comment on that point. Why don't you proceed.

Mr. Shapiro. I actually think that Professor Vedder's comment is a classic case of showing correlation without coming close to proving causality. You can go back to other periods in economic history when the minimum wage was much higher than it was in 1991, and was rising at a faster pace than it did from 1990 to 1991 or 1989 to 1990. In the 1960s, there was a much higher minimum wage rising at a faster rate, and that was one of the best economic expansions in history. I am not saying the minimum wage was responsible for that; neither was it responsible, as you point out so well, Mr. Chairman, for the recent recession.

There were so many other large macroeconomic factors influencing what was going on the economy that an increase in the wage of the lowest paid workers, which only affected about 5 percent of the work force, certainly did not tip off the recession.

Another thing I would like to mention is that the empirical evidence shows just the opposite of Professor Vedder's point. There have been several studies specifically of the increases in 1990 and 1991, and what the effect of those increases were on job formation. For example, the studies would compare employment trends in a state that had relatively high wages to a state that had lots of minimum wage workers, and they examined, "Well, if you have an increase in the minimum wage, you would think that would hurt employment more in the low-wage states, because more of those workers would be affected." But in fact, when that state-by-state analysis was done by Professor Card of Princeton

University, it showed that there was no correlation between the amount of minimum wage workers in the state and employment trends in the state.

Moreover, if you take a time series analysis that goes from 1954 all the way up through 1986, and that attempts to isolate the relationship between the minimum wage and employment trends, it shows that the employment effects are very small.

Representative Obey. Let me turn to a different question.

Mr. Vedder, I don't mean to keep singling you out, but I was so startled by two other things that you said that I do have to respond.

Mr. Vedder. Sure.

Representative Obey. In your prepared statement, you seem to suggest that President Roosevelt's continued efforts to bottle a high-wage policy, trying to bring the country out of the Great Depression, kept the markets from working normally; implying somehow, I think, that the Depression would have been less severe, or we would have worked out of it more easily, if there had been no job program.

When you testified that he continued the high-wage policy through the programs you listed, is it your view that the policies of the 1980s, for instance, were better and a better approach to creating jobs than Roosevelt's?

And, if you are, are you aware of the fact that private-sector employment, following the trough of the 1981-82 recession, grew for one twelve-month period by 6 percent, but for most of the rest of the recovery, it grew at an annual rate of 2 to 3 percent? Whereas, in the period you cite under Roosevelt, it grew at an annual rate of 15 percent, from 1933 through 1937. I guess I have trouble following your logic, given those numbers.

Mr. Vedder. There was a very substantial difference between the 1930s and the 1980s. I am surprised you use that example. Actually, this is one thing that economic historians and theorists pretty much agree on.

One of your witnesses this morning, Professor Solow, has spoken specifically along the same line that I have with regards to the Roosevelt policy. Between June 1933 and December of that year, factory wages rose 22 percent in six months. And the unemployment rate, which had been coming down for several months following the bank holiday in March, shortly stopped falling and stayed constant for two or three years. Then, only after the effects of the National Industrial Recovery Act had been absorbed, and that law had been proved unconstitutional, for a time there was a further reduction in unemployment. Similarly, the Wagner Act in 1937 led to an expansion of wages that year of about 13 percent, and the recovery stopped in its tracks, and we had a rise in unemployment to almost 20 percent in 1938.

Representative Obey. Can you tell me what the fiscal policy was during that same period under Roosevelt? Because, as you know, there was significant action taken by Roosevelt in contracting the economy after his initial efforts to stimulate it.

Mr. Vedder. The Federal Government ran a deficit in most of the years in the 1930s. There is an argument that state and local governments were running surpluses during much of that period, and there is some debate as to the precise amount of the fiscal stimulus, or lack thereof, in the 1930s.

Representative Obey. But you don't deny that over that period, Roosevelt substantially reduced the stimulative activities that he had been pushing earlier in his terms?

Mr. Vedder. I certainly disagree with that, Congressman. I think the New Deal was a great new adventure in government stimulus to the economy. The Works Progress Administration——

Representative Obey. You don't distinguish between different degrees of stimulus in different stages of Roosevelt's presidency during that first term?

Mr. Vedder. The stimulus certainly varied from year to year, and there is an argument in support of what you are saying, actually, in 1937 and 1938 there was a reduction in fiscal stimulus.

Representative Obey. There sure was.

Mr. Vedder. But there was also this wage explosion that I was talking about. There was also monetary changes going on.

To compare job growth from 1933 to 1937, when in March the unemployment rate, I estimate, was at over 27 percent, and compare that with 1981 to 1985, I think, is a little disingenuous, and I——

Representative Obey. Well, then let's go to your statement about World War II. You indicated that, I believe, our post-World War II adjustment was handled quite nicely without the markets, without special efforts at job creation. I guess I have a difficult time following that.

What do you call the GI Bill, which was a huge government effort to upgrade the skills of millions of workers returning from the war? What do you call the housing programs, which had a substantial effect on construction at that time?

If you take a look at the numbers, starting in June 1944, 7.8 million veterans of World War II were enrolled at some time in education and training programs under the GI Bill. There were 2.3 million colleges, 3 to 3 and a half million other schools, 1.4 million job trainees and 700,000 farm trainees. The veterans' housing benefit raised housing starts by 60 percent between 1946 and 1948. Why on earth would those programs not be considered to be job creation and economic stimulus programs?

Mr. Vedder. By the way, I agree with you about the GI Bill. In fact, I wish we had a GI Bill at the public education level today.

With respect to the overall picture, though, the Nation ran from a very substantial budget deficit—which, as I point out in my testimony, would be the equivalent today of over a trillion dollars in calendar 1945—to over a $200 billion budget surplus, putting it in the context of the present size of the economy, in 1946. Housing was not a big factor then, even public housing.

It took a while after the war for these programs to get geared up. The Federal Government let 10 million people go from employment. Most of them went very voluntarily. They were soldiers who were being released. But 10 million people left federal employment. Every economist in the country virtually was predicting unemployment. Some of them were predicting 14 percent, some 10, some 12, including some who went on to win the Nobel Prize, I might add, and yet the unemployment rate never got above 3.9 percent.

Everyone said, well, it is because we had a lot of stimulus in the economy, consumer spending, and it did grow. But it didn't really impact much on the economy in that first critical year after the war. Even auto production wasn't back to normal. And so we had, I think, a market adjustment that worked fairly well. Harry Truman left office with a real public debt per capita that was less than when he came in.

REPRESENTATIVE OBEY. But that is a very different question. You are putting up a strong hand that I didn't build. I am happy that you remind people that Truman was fiscally responsible. In fact, if you take a look at the record of all Democratic presidents in this century compared to Republican presidents, you will find that deficits have increased much faster under the Republican presidents than they have under Democratic ones.

But I think that is beside the point. I was simply challenging your assertion that it was market forces left to their own devices that solved the problem. You know, there were just a few additional activities on the part of government at that time, in addition to the GI Bill and the VA housing programs and all the rest. You also had a little matter of price controls. They were used for a while to mitigate market forces.

I guess my problem with your testimony—and this is the only point I make before I turn to the other witnesses—I think most of the decisions have to be made in this economy by the private sector. But the idea that government has to leave to market forces almost the exclusive responsibility for dealing with these problems is, I think, not very practical.

It just seems to me that the CEO of a corporation has a greater responsibility than the President of the United States. The CEO of a corporation is supposed to maximize the return to the shareholders. The job of the President of the United States is to maximize opportunity for everybody in this society, and I think that demands that government take actions to mitigate the otherwise Darwinist effects of the market. And I think that that is what the President is going to be trying to do.

Let me ask, Mr. Weill, I want to play the devil's advocate with you for a moment. You cited the need to deal with Head Start, to deal with Job Corps. You mentioned earned income tax credit—one of you did. I have forgotten which one. You have listed a number of other items to assist children.

I want to say the same thing that I said to Mr. Marshall. My instincts tell me that all of that is correct. But how do you answer the charges that some people will make that these programs really are not that effective? What data would you cite to demonstrate that the jobs that you are suggesting that we invest in, in fact, will produce results, other than making us feel better because we tossed some dollars at the problem?

MR. WEILL. Well, the effectiveness is manifested in a variety of ways—first of all, in the improved conditions and resources of the children involved, and second, in long-term economic and fiscal savings. Many of these programs create long-term economic and fiscal savings for the country. The studies of Head Start and comparable high quality early childhood development programs show returns of $3 or $4 and more for every dollar invested, in reduced school failure and grade repetition, in reduced welfare costs, and other outcomes.

The studies of childhood immunization show that for every dollar we have spent on childhood immunization in recent decades, we have saved $10 in the other costs. The Job Corps ratio is lower, but roughly a dollar and a half is returned for every dollar spent. And throughout these programs—prenatal care, early health care for infants and toddlers, the WIC program—all of these things have been shown to have very high or relatively high rates of return.

So even if we weren't compelled to do these things morally and out of a sense that our society depends on treating our children and treating each other with some minimum decency, even if those benefits alone didn't drive this, we would be compelled to do it by the returns on the investment.

One thing that we need to do is to look at the returns more broadly. For example, it is our sense that childhood poverty itself is costing this country tens and tens of billions of dollars a year down the road through school dropouts, through teen pregnancy, through higher mental retardation costs, because poor pregnant women and poor babies have higher disability rates, and through other bad outcomes.

We have undertaken a project—Mr. Solow has agreed to assist in an advisory capacity—to try and quantify the cost to this country of sustaining child poverty rates that are two, three, five, ten times those of our economic competitors. We think, in the end, the evidence will show that the country has to eradicate childhood poverty for its own economic well-being.

Representative Obey. Just one other question. In your draft statement, you said:

> The growth in the number of young families, heads of families with children, is in part a reflection of changing values, but the economic hardships associated with fallen earnings and persistent joblessness among young adults also has contributed significantly to failing marriage rates and increasing rates of out-of-wedlock childbearing.

As you know, some would make just the reverse argument, that it was the latter that caused the former. What would your response be to that argument?

Mr. Weill. Well, the evidence from Northeastern University and others is that the wages of young men are a determinant, not the sole determinant, of marriage rates among young adults. Actually, there is also a quote in the testimony from Ben Franklin to that effect, so the phenomenon was noticed a couple of centuries ago—that young men whose incomes are above the poverty level for a family of three or four are several times more likely to get married than are young men whose wages are below the poverty line. There is substantial evidence that, as young men's wages have gone down over the last two decades, and millions more young men have dropped below the family poverty level in their wages, that has contributed to the decline in the marriage rate. There is certainly an array of cultural and other factors that have contributed.

That points out something I wanted to say about Mr. Vedder's testimony. Market forces, of course, don't exist in isolation. There is a culture going on around it. There are a number of forces in effect at any time. After World War II, one way the Nation dealt with the 10 million men who were returning was to have several million women give up their jobs. That helped keep the unemployment rate down. Whereas, in the last three decades, several million additional women have entered the work force.

Mr. Vedder has addressed himself specifically—I am sorry he had to leave—to jobs and not to the effects of lower wages. And our concern is about the effects of lower wages not just on family economic security, but on the ability of families to stay together, families' attachment to the work force and to the broader society. There is a ripple effect of these low-wage strategies that is pulling the society apart. And if we continue to keep young workers' and young children's family incomes down, it is eventually going to threaten the future viability of this society.

REPRESENTATIVE OBEY. I agree with that very much. One of the issues which is getting a lot of discussion lately is the issue of generational equity. And I see some people using their concern about that issue to argue that we ought to make substantial scalebacks on benefits for seniors, for instance. Something which I do not agree with.

But I have never understood why people don't understand, if you don't deal with this issue of earning capacity on the part of the young workers, that really will create much worse generational inequity than, say, a small cost-of-living increase for a senior citizen at the poverty level. And it just seems to me that if we don't deal with this problem at the beginning of the pipeline, it is silly to worry about it at the end of the pipeline, because by then you are too late and you have missed the opportunity to really reduce that generational inequity.

MR. WEILL. I think that is absolutely right. We would certainly agree that the answer to these problems is not to reduce benefits for the elderly. There are too many elderly people living just above the poverty line and struggling. So it is not a question of generational warfare. This country is wealthy enough to adequately support both of its dependent populations through other mean-s—the elderly and children—so we can live in a civilized society and protect the future interests of this country.

What we would hope for from the elderly and older workers is the recognition that investing in children is essential to the viability of social security and the future viability of the country.

REPRESENTATIVE OBEY. Mr. Shapiro, did you have anything to add before we shut it down?

MR. SHAPIRO. No.

REPRESENTATIVE OBEY. All right. Well, thank you both for coming. I am sorry Mr. Vedder had to leave to catch a plane, but I appreciate the time of all of you today.

Tomorrow morning, we will continue with a panel who will be addressing the question of what kinds of investments we can make on the capital side in order to try and improve both the investment picture in the country and the economic performance picture, as well.

Thank you very much.

[Whereupon, at 3:35 p.m., the Committee adjourned, subject to the call of the Chair.]

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SUBMISSIONS FOR THE RECORD

PREPARED STATEMENT OF RAY MARSHALL

"A High-Income, High-Producivity Economic Strategy"

Thank you, Mr. Chairman, for this opportunity to share with you and other members of this committee some of my views on the economic outlook for 1993 and the economic problems facing President Clinton. It is important to distinguish some of the immediate problems the administration faces from the longer-term structural problems facing the American economy. The long- and short-term problems are related, of course, because America's anemic economic recovery and the lack of job growth are due to structural shifts in the U.S. and global economies requiring very different kinds of macro, micro, and international economic policies from those we have followed in the past.

The essential structural problem we face is making the adjustment from the economic system that made the United States the world's leading industrial power in the early part of this century to a more competitive global economy where we have some serious economic disadvantages. Our early economic advantages were due to an abundance of natural resources, a large and growing internal market which made it possible to increase productivity very rapidly through economies of scale and favorable interindustry shifts (like the movement of labor from low-productivity agriculture to higher productivity manufacturing) and supportive economic policies. Especially important economic policies were our mass education system which created what was at one time the world's best educated work force; the land grant colleges and agricultural extension system, which greatly improved the productivity of American agriculture; and the policies of the federal government, beginning in the 1930s, to sustain the production system by generating aggregate demand through monetary-fiscal policy, collective bargaining, social security, worker protections and unemployment compensation. These policies helped usher in the longest period of relatively equitably shared prosperity in our history from the 1930s to the early 1970s.

As you know very well, Mr. Chairman, technological changes and the globalization of markets have eroded the advantages Americans formerly enjoyed. Technological change is essentially the substitution of ideas, skills and knowledge for physical resources. In a knowledge-intensive world, natural resources become less important and human resources become critical to economic success.

Similarly, globalization changes the requirements for economic success and makes it much more difficult to regulate economic activity through traditional economic policies. We now have to be more concerned about the effect of our policies on exports, imports, and exchange rates which can accelerate or nullify the effects of national monetary and fiscal policies.

Some of the most important combined effects of international competition are on the economic competitiveness of businesses. In this new environment, companies, countries, or individuals confront a clear choice: they can either attempt to compete by costs, mainly wages, or they can take measures to improve productivity and quality. Most democratic industrialized economies have rejected the low-wage option because it implies lower and more unequal wages and limits improvements in incomes to working harder. The other option, to improve productivity and quality, requires that we compete by substituting ideas, skills and knowledge for physical resources. We do not know the limits to this option but it clearly implies much steeper learning and earning curves than the low-wage strategy. However, the high-productivity, high-income option requires a concerted economic strategy--it won't just happen. The passive policies we have followed in the United States since the 1970s will automatically lead to a low-wage competitiveness policy. The high productivity strategy therefore requires active policies to discourage low-wage competition and encourage companies to compete by improving productivity and quality. Low-wage competition is discouraged in most

European countries through high social safety nets; active labor market policies; well-trained and well-educated work forces; the empowerment of workers in the work place and in the polity and society; and greater policy stability through consensus-building processes. The absence of these policies and processes in the United States has permitted us to back into low-wage competition. As a consequence, productivity growth in the United States has been stagnant, real wages for most workers are lower now than they were in 1970, and American wages are more unequal than at any time in the post-war period.

I do not have time to outline all that is required to restore the United States to the high-productivity track. We know, however, that we must provide incentives for companies to become high-performance organizations. High-performance organizations stress quality, productivity, and flexibility through work organizations that provide a high degree of worker participation in work place decisions; the development and use of leading-edge technology; continuing education and training of *all* workers, not just managers; positive incentive structures instead of the negative or perverse incentives found in many American work places; and an independent source of power for workers.

My list of the things that we should do immediately include:

1. Develop consensus to be a high-productivity, high-income country.
2. Develop an investment-led growth program that would stimulate the economy immediately through measures that would strengthen our long-run productive potential, including:
   a. A temporary minimum $60 billion annual fiscal stimulus, consisting of $50 billion in grants to state and local governments and a $10 billion new investment tax credit for new investment.
   b. A longer-term permanent program for targeted investment, mainly through state and local governments, for education, training, infrastructure (especially 21st century information and transportation infrastructure).
   c. A credible pre-committed plan to reduce the budget deficit absolutely and as a percentage of GDP as economic growth picks up.
   d. A business-labor-government commission to build consensus on long-term strategies to promote high levels of growth in productivity and output without inflation.
   e. An agreement with the Federal Reserve to coordinate economic policy to reduce real interest rates to support long-term growth policies.

It also would be useful for President Clinton to take the lead to modernize international economic institutions and policies to support high-income, high-productivity economic strategies in all countries and to provide adequate global economic growth. Such policies require transparent, fair, and enforceable rules for international transitions that would include services, intellectual property rights, and labor and environmental protections.

I was one of the economists supporting the proposal formulated by James Tobin and Robert Solow for a $50 billion a year investment program to strengthen the American economy. Fifty billion dollars represents about 1 percent of GDP. This proposal was made last March, but I have seen nothing to justify changing the value of this proposal. The first phase of the investment program could be in the form of temporary emergency grants to states for programs based on clear need and capacity to spend on sensible projects. This program, along with the temporary $10 billion investment tax cut, should continue at least through fiscal 1994. Thereafter, a $50 billion a year targeted investment program should continue for the rest of this decade. At least $25 billion is needed to maintain the nation's infrastructure and another $25 billion to close the gap between the United States and other major industrial countries.

There are a number of options for paying for this program. I favor an immediate 8 percent energy tax which would yield approximately $30 billion a year. However, I believe we should consider shifting to a progressive value-added tax in the longer term and reducing our dependence on corporate and personal income taxes. I would give careful consideration to the infrastructure investment bank proposal by Felix Rohatyn and Carol O'Cleireacain. This proposal would issue bonds to be repaid by dedicated taxes.

Additional resources could come from a $150 billion cut in defense spending, as proposed by Senator James Sasser, Chairman of the Senate Budget Committee, and other deficit reduction measures. I also would restore some progressiveness in the income tax by a 36 percent marginal tax rate on incomes over $200,000 a year, to be used to reduce the income taxes of middle class tax payers. Other tax changes could be levied to bring in another $30 billion a year, including a Medicare payroll tax, taxing capital gains at death, and limiting mortgage interest payments.

Simulations by the Economic Policy Institute, on whose board I serve, show an investment program of $50 billion over an eight-year period would do more than either an austerity program or a more modest "muddling through" strategy to strengthen the economy and reduce the long-run budget deficit as a percentage of GDP; the investment strategy produces a budget deficit of 1.8 percent of GDP by 2000, compared with 3.8 percent for muddling through and 2.4 percent for austerity. Importantly, the investment strategy produces $1 trillion more investment over the 8-year period (see Table 1).

A major deterrent to the investment-led strategy is the fear of inflation and continuing growth in budget deficits. I do not believe we face a serious inflationary threat in the immediate future, but these problems should be dealt with in a credible fashion *before* they become serious threats. A credible deficit reduction program over the longer term could be developed by enacting deficit-reducing measures immediately that would become effective in two to three years after the investment-induced growth takes effect. It would, however, be a serious mistake to reduce the budget deficit before economic growth picks up. There is no evidence that budget deficits are currently crowding out private investment.

A Human Resource Development Strategy

Mr. Chairman, I believe it is particularly urgent for the United States to adopt a comprehensive human resource development strategy to improve the education, skills, and health of our people. A group associated with the National Center on Education and the Economy, of which I am a trustee, has proposed such a strategy to the Clinton administration (NCEE, *A Human Resource Development Plan for the United States*, 1993), and Marc Tucker and I elaborate the need for such a strategy in our book, *Thinking for a Living* (Basic Books, 1992).

The legislative agenda we propose includes measures to improve our schools through a system of national performance standards benchmarked to the highest in the world. A national education system should be established linking curricula, pedagogy, examinations and teacher education to the national standards. This system would permit substantial variation among the states and local school districts, but would abandon the American tracking system and make schools responsible for ensuring that all students meet the high standards required for graduation. Student who meet the high standards for graduation should be rewarded by further education and rewarding careers.

Schools would be reorganized to reduce administrative personnel and rules and regulations that have little to do with student achievement. School professionals would be freed to make the key decisions to bring students up to the standards, and school professionals should receive adequate compensation and support needed to do their jobs.

Postsecondary Education And Work Skills

All students who meet high standards for general education should be entitled to three years of additional free education. Loans, which could be forgiven for public service, should be available for additional education.

National standards, established with the participation of employers, labor, and academics, should be established for sub-baccalaureate college-level technical certificates.

These programs should include academic and structural on-the-job training and should be linked to baccalaureate and higher degrees.

There also should be a system of on-the-job training and education for all workers paid for through a requirement that employers spend an amount equal to 1.5 percent of payroll on training for all workers leading to a national skill certification.

Labor Market Systems

One of the most important problems for employment and training in the United States is the absence of a coherent labor market system. We therefore should establish a system of labor market boards at the local, state, and federal levels to coordinate job training, postsecondary technical education, adult basic education, job matching, and counseling. The Employment Service should be upgraded, separated from the Unemployment Insurance Fund, and supervised by these boards. This system should provide readily accessible counselors to any person to help assess needs, plan and finance a training and education program, and locate available jobs. Clients of the labor market boards should be able to have all of their needs addressed at a local labor office.

Mr. Chairman, this summarizes our recommendations. I believe these recommendations would go a long way toward developing a high-productivity, high-income strategy for the United States. The Clinton administration and the Congress face serious economic problems, but they also have a golden opportunity to make a dramatic shift in our economic policies. The alternative is to continue to experience growing inequality of opportunity and economic stagnation. It seems to me that the path we should take is very clear.

Thank you. I would be glad to answer questions you or other members of the committee might have.

Table 1

Long-Term Investment Strategy Effect
(EPI Baseline, Fiscal Years)

		FIRST TERM				SECOND TERM			
	1992	1993	1994	1995	1996	1997	1998	1999	2000
Real GDP									
Austerity		4975	5059	5139	5224	5308	5393	5479	5566
Muddle-Through	4875	4975	5075	5183	5288	5386	5478	5571	5664
Investment		5000	5158	5256	5341	5480	5628	5785	5953
GDP									
Austerity		6139	6412	6696	7006	7328	7665	8018	8387
Muddle-Through	5854	6139	6435	6763	7116	7460	7808	8169	8542
Investment		6173	6553	6888	7208	7613	8047	8514	9017
Unemployment Rate									
Austerity		7.1	6.6	6.5	6.4	6.7	7.0	7.3	7.6
Muddle-Through	7.3	7.1	6.5	6.2	5.9	6.0	6.1	6.2	6.3
Investment		6.7	5.7	5.6	5.8	5.8	5.8	5.8	5.8
Investment									
Austerity		361	373	382	394	408	422	437	452
Muddle-Through	345	361	375	391	408	422	433	450	465
Investment		363	391	413	432	467	504	544	588
Deficit (NIPA basis)									
Austerity		284	236	231	229	201	151	173	198
As a % of GDP		4.6	3.7	3.4	3.3	2.7	2.0	2.2	2.4
Muddle-Through	287	284	274	295	313	327	327	328	325
As a % of GDP	4.9	4.6	4.3	4.4	4.4	4.4	4.2	4.0	3.8
Investment		298	280	301	275	249	219	189	159
As a % of GDP		4.8	4.3	4.4	3.8	3.3	2.7	2.2	1.8
Deficit (Unified Budget basis)									
Austerity		357	278	253	232	207	150	172	200
As a % of GDP		5.8	4.3	3.8	3.3	2.8	2.0	2.1	2.4
Muddle-Through	316	357	316	317	316	333	326	327	327
As a % of GDP	5.4	5.8	4.9	4.7	4.4	4.5	4.2	4.0	3.8
Investment		371	322	323	278	255	218	188	161
As a % of GDP		6.0	4.9	4.7	3.9	3.3	2.7	2.2	1.8

Note: Muddle-Through and Investment scenarios assume healthcare reform savings beginning in FY97; the Austerity scenario assumes such savings beginning in FY94.

Source: Economic Policy Institute, Letter from Jeff Faux to President-elect Clinton, November 18, 1992

ATTACHMENT TO MR. MARSHALL'S PREPARED STATEMENT

A Human Resources Development Plan *for the United States*

NATIONAL CENTER ON EDUCATION AND THE ECONOMY

Preface

The advent of the Clinton administration creates a unique opportunity for the country to develop a truly national system for the development of its human resources, second to none on the globe. The National Center on Education and the Economy and its predecessor organization, the Carnegie Forum on Education and the Economy, have been elaborating a national agenda in this arena over the last eight years. Here, we outline a set of recommendations to the incoming Clinton administration in the area of human resources development. It builds directly on the proposals that the President-elect advanced during the campaign. This report is mainly the work of a small group of people with close ties to the National Center: Tim Barnicle, David Barram, Michael Cohen, David Haselkorn, David Hornbeck, Shirley Malcom, Ray Marshall, Susan McGuire, Hilary Pennington, Andy Plattner, Lauren Resnick, David Rockefeller, Jr., Betsy Brown Ruzzi, Robert Schwartz, John Sculley, Marshall Smith, Bill Spring and myself. While all of these people are in general agreement with what follows, they may not agree on the details.

— *Marc Tucker*

Introduction

The great opportunity in front of the country now is to remold the entire American system for human resources development, almost all of the current components of which were put in place before World War II. The natural course is to take each of the ideas that were advanced in the campaign in the area of education and training and translate them individually into legislative proposals. But that will lead to these programs being grafted onto the present system, not to a new system, and the opportunity will have been lost. If this sense of time and place is correct, it is essential that the nation's efforts be guided by a consistent vision of what it wants to accomplish in the field of human resources development, a vision that can shape the actions not only of the new administration but of many others over the next few years.

What follows comes in two pieces:

First, a vision of the kind of national — not federal — human resources development system the nation could have. This is interwoven with a new approach to governing that should inform that vision. What is essential is that we create a seamless web of opportunities to develop one's skills that literally extends from cradle to grave and is the same system for everyone — young and old, poor and rich, worker and full-time student. It needs to be a system *driven by client needs* (not agency regulations or the needs of the organizations providing the services), *guided by clear standards* that define the stages of the system for the people who progress through it, and *regulated on the basis of outcomes* that providers produce for their clients, not inputs into the system.

Second, a proposed legislative agenda the new administration and the Congress can use to implement this vision. We propose four *high priority* packages that will enable the federal government to move quickly:

1. The *first* would use the President-elect's proposal for an *apprenticeship* system as the keystone of a strategy for putting a whole new postsecondary training system in place. That system would incorporate his proposal for reforming *postsecondary education finance*. It contains what we think is a powerful idea for rolling out and scaling up the whole new human resources system nationwide over the next four years, using the (renamed) apprenticeship idea as the entering wedge.

2. The *second* would combine initiatives on dislocated workers, a rebuilt employment service and a new system of labor market boards in a single *employment security* program, built on the best practices anywhere in the world. This is the backbone of a system for assuring adult workers in our society that they need never again watch with dismay as their jobs disappear and their chances of ever getting a good job again go with them.

3. The *third* would concentrate on the overwhelming problems of our *inner cities*, combining elements of the first and second packages into a special program to greatly raise the work-related skills of the people trapped in the core of our great cities.

4. The *fourth* would enable the new administration to take advantage of legislation on which Congress has already been working to advance the *elementary and secondary reform* agenda.

The Vision

An Economic Strategy Based on Skill Development

- The economy's strength is derived from a whole population as skilled as any in the world, working in workplaces organized to take maximum advantage of the skills those people have to offer.

- A seamless system of unending skill development that begins in the home with the very young and continues through school, postsecondary education and the workplace.

The Schools

- Clear national standards of performance in general education (the knowledge and skills that everyone is expected to hold in common) are set to the level of the best achieving nations in the world for students of 16 and public schools are expected to bring all but the most severely handicapped up to that standard. Students get a certificate when they meet this standard, allowing them to go on to the next stage of their education. Though the standards are set to international benchmarks, they are distinctly American, reflecting our needs and values.

- We have a national system of education in which curriculum, pedagogy, examinations and teacher education and licensure systems are all linked to the national standards, but which provides for substantial variation among states, districts and schools on these matters. This new system of linked standards, curriculum and pedagogy will abandon the American tracking system, combining high academic standards with the ability to apply what one knows to real world problems and qualifying all students for a lifetime of learning in the postsecondary system and at work.

- We have a system that rewards students who meet the national standards with further education and good jobs, providing them a strong incentive to work hard in school.

- Our public school systems are reorganized to free up school professionals to make the key decisions about how to use all the available resources to bring students up to the standards. Most of the federal, state, district and union rules and regulations that now restrict school professionals' ability to make these decisions are swept away, though strong measures are in place to make sure that vulnerable populations get the help they need. School professionals are paid at a level comparable to that of other professionals, but they are expected to put in a full year, to spend whatever time it takes to do the job and to be fully accountable for the results of their work. The federal, state and local governments provide the time, staff development resources, technology and other support needed for them to do the job. Nothing less than a wholly restructured school system can possibly bring all of our students up to a standard only a few have been expected to meet up to now.

- There is an aggressive program of public choice in our schools.

- All students are guaranteed that they will have a fair shot at reaching the standards, that is, that whether they make it or not depends only on the effort they are willing to make. A determined effort on the part of the federal government will be required on this point. School delivery standards may be required. If so, these standards should have the same status in the system as the new student performance standards, but they should be fashioned so as not to constitute a new bureaucratic nightmare.

Postsecondary Education and Work Skills

- All students who meet the new national standards for general education are entitled to the equivalent of three more years of free additional education. We would have the federal and state governments match funds to guarantee one free year of college education to everyone who meets the new national standards for general education (the amount of this award would be set at a stipulated maximum so as to avoid runaway charges for college tuition). So a student who meets the standard at 16 would be entitled to two free years of high school and one of college. Loans, which can be forgiven for public service, are available for additional education beyond that. National standards for sub-baccalaureate college-level professional and technical degrees and certificates will be established with the participation of employers, labor and higher education. These programs will include both academic study and structured on-the-job training. Eighty percent or more of American high school graduates will be expected to get some form of college degree, though most of them less than a baccalaureate. These new professional and technical certificates and degrees typically are won within three years of acquiring the general education certificate, so, for most postsecondary students, college will be free. These professional and technical degree programs will be designed to link to programs leading to the baccalaureate degree and higher degrees. There will be no dead ends in this system. Everyone who meets the general education standard will be able to go to some form of college, being able to borrow all the money they need to do so, beyond the first free year.

  This idea of post-secondary professional and technical certificates captures all of the essentials of the apprenticeship idea, while offering none of its drawbacks (see below). But it also makes it clear that those engaged in apprentice-style programs are getting more than narrow training; they are continuing their education for other purposes as well, and building a base for more education later. Clearly, this idea redefines college. Proprietary schools, employers, and community-based organizations will want to offer these programs, as well as community colleges and four-year institutions, but these new entrants will have to be accredited if they are to qualify to offer the programs.

- Employers are not required to provide slots for the structured on-the-job training component of the program but many do so, because they get first access to the most accomplished graduates of these programs and they can use these programs to introduce the trainees to their own values and way of doing things.

- The system of skill standards for technical and professional degrees is the same for students just coming out of high school and for adults in the workforce. It is progressive, in the sense that certificates and degrees for the entry level jobs lead to further professional and technical education programs at higher levels. Just as in the case of the system for the schools, though the standards are the same everywhere (leading to maximum mobility for students), the curricula can vary widely and programs can be custom designed to fit the needs of full-time and part-time students with very different requirements. Government grant and loan programs are available on the same terms to full-time and part-time students, as long as the programs in which they are enrolled are designed to lead to certificates and degrees defined by the system of professional and technical standards.

- The national system of professional and technical standards is designed much like the multistate bar, which provides a national core around which the states can specify additional standards that meet their unique needs. There are national standards and exams for no more than 20 broad occupational areas, each of which can lead to many occupations in a number of related industries. Students who qualify in any one of these areas have the broad skills required by a whole family of occupations, and most are sufficiently skilled to enter the workforce immediately, with further occupation-specific skills provided by their union or employer. Industry and occupational groups can voluntarily create standards building on these broad standards for their own needs, as can the states. Students entering the system are first introduced to very broad occupational groups, narrowing over time to concentrate on acquiring the skills needed for a cluster of occupations. This modular system provides for the initiative of particular states and industries while at the same time providing for mobility across states and occupations by reducing the time and cost entailed in moving from one occupation to another. In this way, a balance is established between the kinds of generic skills needed to function effectively in high performance work organizations and the skills needed to continue learning quickly and well through a lifetime of work, on the one hand, and the specific skills needed to perform at a high level in a particular occupation on the other.

- Institutions receiving grant and loan funds under this system are required to provide information to the public and to government agencies in a uniform format. This information covers enrollment by program, costs and success rates for students of different backgrounds and characteristics, and career outcomes for those students, thereby enabling students to make informed choices among institutions based on cost and performance. Loan defaults are reduced to a level close to zero, both because programs that do not deliver what they promise are not selected by prospective students and because the new postsecondary loan system uses the IRS to collect what is owed from salaries and wages as they are earned.

Education and Training for Employed and Unemployed Adults

- The national system of skills standards establishes the basis for the development of a coherent, unified training system. That system can be accessed by students coming out of high school, employed adults who want to improve their prospects, unemployed adults who are dislocated and others who lack the basic skills required to get out of poverty. But it is all the same system. There are no longer any parts of it that are exclusively for the disadvantaged, though special measures are taken to make sure that the disadvantaged are served. It is a system for everyone, just as all the parts of the system already described are for everyone. So the people who take advantage of this system are not marked by it as damaged goods. The skills they acquire are world class, clear and defined in part by the employers who will make decisions about hiring and advancement.

- The new general education standard becomes the target for all basic education programs, both for school dropouts and adults. Achieving that standard is the prerequisite for enrollment in all professional and technical degree programs. A wide range of agencies and institutions offer programs leading to the general education certificate, including high schools, dropout recovery centers, adult education centers, community colleges, prisons and employers. These programs are tailored to the needs of the people who enroll in them. All the programs receiving government grant or loan funds that come with dropouts and adults for enrollment in programs preparing students to meet the general education standard must release the same kind of data required of the postsecondary institutions on enrollment, program description, cost and success rates. Reports are produced for each institution and for the system as a whole showing different success rates for each major demographic group.

- The system is funded in four different ways, all providing access to the same or a similar set of services. School dropouts below the age of 21 are entitled to the same amount of funding from the same sources that they would have been entitled to had they stayed in school. Dislocated workers are funded by the federal government through the federal programs for that purpose and by state unemployment insurance funds. The chronically unemployed are funded by federal and state funds established for that purpose. Employed people can access the system through the requirement that their employers spend an amount equal to 1 and 1/2 percent of their salary and wage bill on training leading to national skill certification. People in prison could get reductions in their sentences by meeting the general education standard in a program provided by the prison system. Any of these groups can also use the balances in their grant entitlement or their access to the student loan fund.

Labor Market Systems

- The Employment Service is greatly upgraded, and separated from the Unemployment Insurance Fund. All available front-line jobs — whether public or private — must be listed in it by law [this provision must be carefully designed to make sure that employers will not be subject to employment suits based on the data produced by this system — if they are subject to such suits, they will not participate]. All trainees in the system looking for work are entitled to be listed in it without a fee. So it is no longer a system just for the poor and unskilled, but for everyone. The system is fully computerized. It lists not only job openings and job seekers (with their qualifications) but also all the institutions in the labor market area offering programs leading to the general education certificate and those offering programs leading to the professional and technical college degrees and certificates, along with all the relevant data about the costs, characteristics and performance of those programs — for everyone and for special populations. Counselors are available to any citizen to help them assess their needs, plan a program and finance it, and, once they are trained, to locate available jobs.

- A system of labor market boards is established at the local, state and federal levels to coordinate the systems for job training, postsecondary professional and technical education, adult basic education, job matching and counseling. The rebuilt Employment Service is supervised by these boards. The system's clients no longer have to go from agency to agency filling out separate applications for separate programs. It is all taken care of at the local labor market board office by one counselor accessing the integrated computer-based program, which makes it possible for the counselor to determine eligibility for all relevant programs at once, plan a program with the client and assemble the necessary funding from all the available sources. The same system will enable counselor and client to array all the relevant program providers side by side, assess their relative costs and performance records and determine which providers are best able to meet the client's needs based on performance.

Some Common Features

- Throughout, the object is to have a performance- and client-oriented system and to encourage local creativity and responsibility by getting local people to commit to high goals and organize to achieve them, sweeping away as much of the rules, regulations and bureaucracy that are in their way as possible, provided that they are making real progress against their goals. For this to work, the standards at every level of the system have to be clear; every client has to know what they have to accomplish in order to get what they want out of the system. The service providers have to be supported in the task of getting their clients to the finish line and rewarded when they are making real progress toward that goal. We would sweep away means-tested programs, because they stigmatize their recipients and alienate the public, replacing them with programs that are for everyone, but also work for the disadvantaged. We would replace rules defining inputs with rules defining outcomes and the rewards for achieving them. This means, among other things, permitting local people to combine many federal programs as they see fit, provided that the intended beneficiaries are progressing toward the right outcomes. We would make individuals, their families and whole communities the unit of service, not agencies, programs and projects. Wherever possible, we would have service providers compete with one another for funds that come with the client, in an environment in which the client has good information about the cost and performance record of the competing providers. Dealing with public agencies — whether they are schools or the employment service — should be more like dealing with Federal Express than with the old Post Office.

An Agenda for the Federal Government

Government at every level has an enormous potential for affecting a nation's human capacity — from the resources it provides to nourish pregnant women to the incentives it provides to employers to invest in the skill development of their employees. In this section we concentrate on the role the federal government can play and largely restrict our field of vision to elementary and secondary education, job training and labor market policy.

Everything that follows is cast in the frame of strategies for bringing the new system described in the preceding section into being, not as a pilot program, not as a few demonstrations to be swept aside in another administration, but everywhere, as the new way of doing business.

The preceding section presented a vision of the system we have in mind chronologically from the point of view of an individual served by it. Here we reverse the order, starting with a description of program components designed to serve adults, and working our way down to the very young.

High Skills for Economic Competitiveness Program

Developing System Standards

- Create a National Board for Professional and Technical Standards. The Board is a private not-for-profit chartered by Congress. Its charter specifies broad membership composed of leading figures from higher education, business, labor, government and advocacy groups. The Board can receive appropriated funds from Congress, private foundations, individuals and corporations. Neither Congress nor the executive branch can dictate the standards set by the Board. But the Board is required to report annually to the President and the Congress in order to provide for public accountability. It is also directed to work collaboratively with the states and cities involved in the Collaborative Design and Development Program (see below) in the development of the standards.
- Charter specifies that the National Board will set broad performance standards (not time-in-the-seat standards or course standards) for postsecondary Professional and Technical certificates and degrees at the sub-baccalaureate level, in not more than 20 areas and develops performance examinations for each. The Board is required to set broad standards of the kind described in the vision statement above, and is not permitted to simply reify the narrow standards that characterize many occupations now (more than 2,000 standards currently exist, many for licensed occupations — these are not the kinds of standards we have in mind). It also specifies that the programs leading to these certificates and degrees will combine time in the classroom with time at the work-site in structured on-the-job training. The Board is responsible for administering the exam system and continually updating the standards and exams. The standards assume the existence of prerequisite world class general education standards set by the National Board for Student Achievement Standards, described below. The new standards and exams are meant to be supplemented for particular occupations by the states and by individual industries and occupational groups, with support from the National Board.
- Legislation creating the Board is sent to the Congress in the first six months of the administration, imposing a deadline for creating the standards and the exams within three years of passage of the legislation.

Commentary:

The proposal reframes the Clinton apprenticeship proposal as a college program and establishes a mechanism for setting the standards for the program. The unions are very concerned that the new apprenticeships will be confused with the established registered apprenticeships. Focus groups conducted by Jobs for the Future and others show that parents everywhere want their kids to go to college, not to be shunted aside into a non-college apprenticeship "vocational" program. By requiring these programs to be a combination of classroom instruction and structured OJT, and creating a standard-setting board that includes employers and labor, all the objectives of the apprenticeship idea are achieved, while at the same assuring much broader support for the idea, as well as a guarantee that the program will not become too narrowly focussed on particular occupations. It also ties the Clinton apprenticeship idea to the Clinton college funding proposal in a seamless web. Charging the Board with creating not more than 20 certificate or degree categories establishes a balance between the need *to create one national system on the one hand with the need to avoid creating a cumbersome and rigid national bureaucracy on the other. This approach provides lots of latitude for individual industry groups, professional groups and state authorities to establish their own standards, while at the same time avoiding the chaos that would surely result if they were the only source of standards. The bill establishing the Board should also authorize the executive branch to make grants to industry groups, professional societies, occupational groups and states to develop their own standards and exams. Our assumption is that the system we are proposing will be managed so as to encourage the states to combine the last two years of high school and the first two years of community college into three-year programs leading to college degrees and certificates. Proprietary institutions, employers and community-based organizations could also offer these programs, but they would have to be accredited to offer these college-level programs. Eventually, students getting their general education certificates might go directly to community college or to another form of college, but the new system should not require that.*

Collaborative Design and Development Program

The object is to create a single comprehensive system for professional and technical education that meets the requirements of everyone from high school students to skilled dislocated workers, from the hard core unemployed to employed adults who want to improve their prospects. Creating such a system means sweeping aside countless programs, building new ones, combining funding authorities, changing deeply embedded institutional structures, and so on. The question is how to get from where we are to where we want to be. Trying to ram it down everyone's throat would engender overwhelming opposition. Our idea is to draft legislation that would offer an opportunity for those states — and selected large cities — that are excited about this set of ideas to come forward and join with each other and with the federal government in an alliance to do the necessary design work and actually deliver the needed services on a fast track. The legislation would require the executive branch to establish a competitive grant program for these states and cities and to engage a group of organizations to offer technical assistance to the expanding set of states and cities engaged in designing and implementing the new system. This is not the usual large scale experiment nor is it a demonstration program, but a highly regarded precedent exists for this approach in the National Science Foundation's SSI program. As soon as the first set of states is engaged, another set would be invited to participate, until most or all of the states are involved. It is a collaborative design, rollout and scale-up program. It is intended to parallel the work of the National Board for Professional and Technical Standards, so that the states and cities (and all (and all their partners) would be able to implement the new standards as soon they become available, although they would be delivering services on a large scale before that happened. Thus, major parts of the whole system would be in operation in a majority of the states within three years from the passage of the initial legislation. Inclusion of selected large cities in this design is not an afterthought. We believe that what we are proposing here for the cities is the necessary complement to a large scale job-creation program for the cities. Skill development will not work if there are no jobs, but job development will not work without a determined effort to improve the skills of city residents. This is the skill development component.

- Participants
  - Volunteer states, counterpart initiative for cities.
  - 15 states, 15 cities selected to begin in first year, 15 more in each successive year.
  - 5 year grants (on the order of $20 million per year to each state, lower amounts to the cities) given to each, with specific goals to be achieved by the third year, including program elements in place (e.g., upgraded employment service), number of people enrolled in new professional and technical programs, and so on.
- Criteria for Selection
  - A core set of High Performance Work Organization firms willing to participate in standard setting and to offer training slots and mentors.
  - Strategies for enriching existing coop ed, tech prep, other programs to meet the criteria.
  - Commitment to implementing new general education standard in legislation.
  - Commitment to implementing the new Technical and Professional skills standards for college.
  - Commitment to developing an outcome- and performance-based system for human resources development.
  - Commitment to new role for employment service.
  - Commitment to join with others in national design and implementation activity.
- Clients
  - Young adults entering workforce.
  - Dislocated workers.
  - Long term unemployed.
  - Employed who want to upgrade skills.
- Program Components
  - Institute own version of state and local labor market boards. Local labor market boards to involve leading employers, labor representatives, educators and advocacy group leaders in running the redesigned employment service, running intake system for all clients, counseling all clients, maintaining the information system that will make the vendor market efficient and organizing employers to provide job experience and training slots for school youth and adult trainees.
  - Rebuild employment service as a primary function of labor market boards.
  - Develop programs to bring dropouts and illiterate up to general education certificate standard. Organize local alternative providers and firms to provide alternative education, counseling, job experience and placement services to these clients.

- Develop programs for dislocated workers and hard-core unemployed (see below).

- Develop city- and state-wide programs to combine the last two years of high school and the first two years of colleges into three year programs after acquisition of the general education certificate to culminate in college certificates and degrees. These programs should combine academics and structured on-the-job training.

- Develop uniform reporting system for providers, requiring them to provide information in that format on characteristics of clients, their success rates by program, and the costs of those programs. Develop computer-based system for combining this data at local labor market board offices with employment data from state so that counselors and clients can look at programs offered by colleges and other vendors in terms of cost, client characteristics, program design, and outcomes, including subsequent employment histories for graduates.

- Design all programs around the forthcoming general education standards and the standards to be developed by the National Board for Professional and Technical Standards.

- Create statewide program of technical assistance to firms on high performance work organization and to help them develop quality programs for participants in Technical and Professional certificate and degree programs (it is essential that these programs be high quality, nonbureaucratic and voluntary for the firms).

- Participate with other states, and the national technical assistance program in the national alliance effort to exchange information and assistance among all participants.

❖ National Technical Assistance to Participants

- Executive branch authorized to compete opportunity to provide the following services (probably using a Request For Qualifications):

  - State-of-the art assistance to the states and cities related to the principal program components (e.g.; work reorganization, training, basic literacy, funding systems, apprenticeship systems, large scale data management systems, training systems for the human resources professionals who make the whole system work, etc.). A number of organizations would be funded. Each would be expected to provide information and direct assistance to the states and cities involved, and to coordinate their efforts with one another.

  - It is essential that the technical assistance function include a major professional development component to make sure the key people in the states and cities upon whom success depends have the resources available to develop the high skills required. Some of the funds for this function should be provided directly to the states and cities, some to the technical assistance agency.

  - Coordination of the design and implementation activities of the whole consortium, documentation results, preparation of reports, etc. One organization would be funded to perform this function.

Dislocated Workers Program

❖ New legislation would permit combining all dislocated workers programs at redesigned employment service office. Clients would, in effect, receive vouchers for education and training in amounts determined by the benefits for which they qualify. Employment service case managers would qualify client worker for benefits and assist the client in the selection of education and training programs offered by provider institutions. Any provider institutions that receive funds derived from dislocated worker programs are required to provide information on costs and performance of programs in uniform format described above. This consolidated and voucherized dislocated workers program would operate nationwide. It would be integrated with the Collaborative Design and Development Program in those states and cities in which that program functioned. It would be built around the general education certificate and the Professional and Technical Certificate and Degree Program as soon as those standards were in place. In this way, programs for dislocated workers would be progressively and fully integrated with the rest of the national education and training system.

Levy-Grant System

❖ This is the part of the system that provides funds for currently employed people to improve their skills. Ideally, it should specifically provide means whereby front-line workers can earn their general education credential (if they do not already have one) and acquire Professional and Technical Certificates and degrees in fields of their choosing.

❖ Everything we have heard indicates virtually universal opposition in the employer community to the proposal for a 1 and 1/2 percent levy on employers for training to support the costs associated with employed workers gaining these skills, whatever the levy is called. The President may choose to press forward with this proposal nevertheless. Alternatively, he could take a leaf out of the German book. One of the most important reasons that large German employers offer apprenticeship slots to German youngsters is that they fear, with good reason, that if they don't volunteer to do so, the law will require it. The President could gather a group of leading executives and business organization leaders, and tell them straight out that he will hold back on submitting legislation to require a training levy, provided that they commit themselves to a drive to get employers to get their average expenditures on front-line employee training up to two percent of front-line employee salaries and wages within two years. If they have not done so within that time, then he will expect their support when he submits legislation requiring the training levy. He could do the same thing with respect to slots for structured on-the-job training.

College Loan/Public Service Program

❖ This proposal was a keystone of the Clinton campaign. Because we assumed that it is being designed by others, we did not focus on its details. From everything we know about it, however, it is entirely compatible with the rest of what is proposed here. What is, of course, especially relevant here, is that our reconceptualization of the apprenticeship proposal as a college-level education program, combined with our proposal that everyone who gets the general education credential be entitled to a free year of higher education (combined federal and state funds) will have a decided impact on the calculations of cost for the college loan/public service program.

Assistance for Dropouts and the Long-Term Unemployed

- The problem of upgrading the skills of high school dropouts and the adult hard core unemployed is especially difficult. It is also at the heart of the problem of our inner cities. All the evidence indicates that what is needed is something with all the important characteristics of a non-residential Job Corps-like program. The problem with the Job Corps is that it is operated directly by the federal government and is therefore not embedded at all in the infrastructure of local communities. The way to solve this problem is to create a new urban program that is locally — not federally — organized and administered, but which must operate in a way that uses something like the federal standards for contracting for Job Corps services. In this way, local employers, neighborhood organizations and other local service providers could meet the need, but requiring local authorities to use the federal standards would assure high quality results. Programs for high school dropouts and the hard-core unemployed would probably have to be separately organized, though the services provided would be much the same. Federal funds would be offered on a matching basis with state and local funds for this purpose. These programs should be fully integrated with the revitalized employment service. The local labor market board would be the local authority responsible for receiving the funds and contracting with providers for the services. It would provide diagnostic, placement and testing services. We would eliminate the targeted jobs credit and use the money now spent on that program to finance these operations. Funds can also be used from the JOBS program in the welfare reform act. This will not be sufficient, however, because there is currently no federal money available to meet the needs of hard-core unemployed males (mostly Black) and so new monies will have to be appropriated for that purpose.

Elementary and Secondary Education Program

The situation with respect to elementary and secondary education is very different from adult education and training. In the latter case, a new vision and a whole new structure is required. In the former, there is increasing acceptance of a new vision and structure among the public at large, within the relevant professional groups and in Congress. There is also a lot of existing activity on which to build. So our recommendations here are rather more terse than in the case of adult education and training.

The general approach here is parallel to the approach described for the High Skills for Economic Competitiveness Program. Here, too, we start with standards. And we propose a collaborative program with the states and with the major cities (adding, in this case, areas suffering from rural poverty) that provides an opportunity for those that wish to do so to participate in a staged, voluntary and progressive implementation of the new system. The parallelism is deliberate. Some states and cities may wish to participate in both programs, developing the whole system at once, others in only one. Much of what we propose can be accomplished through revisions to the conference report on S2 and HR 4323, recently defeated on a cloture vote in the Congress. Solid majorities were behind the legislation in both houses of Congress.

Standard Setting

- Legislation to accelerate the process of national standard setting in education was contained in the conference report on S2 and HR 4323. The new administration should support the early introduction of this legislation to create a National Board for Student Achievement Standards. The Board should be established as an independent not-for-profit organization chartered by the United States Congress. The charter should establish a self-perpetuating board of trustees for the Board that is broadly representative of the American people, including representation of general government at all levels, education, employers, labor, child advocacy groups and the general public. It should be eligible to receive funds from private foundations, government (including funds directly appropriated by the Congress), corporations and individuals. It should be charged with coming to a consensus on content standards for the core subjects in elementary and secondary education and for work-related skills. We do not believe that it should be charged with developing a national examination system, but that funds should be appropriated by the Congress to enable the Executive Branch to provide support to a variety of groups that come forward to implement examination systems based on the standards established by the Board. The Board should be required to report annually to the Congress and the public, whether or not it receives Congressional appropriations.

Systemic Change in Public Education: A Collaborative Design and Development Program

As we noted above, the conference report on S2 and HR 4323 contained a comprehensive program to support systemic change in public education upon which we would build. Here again, we would invite the states to submit proposals in a competitive grant program on the same principles and for the same reasons we suggested that approach above. Each year, additional states — and, in this case, major cities and poor rural areas — would be added to the network. Here again, most of the existing rules and regulations affecting relevant federal education programs would be waived, save for those relating to health, public safety and civil rights, and the participants would be expected to specify objectives for specific demographic groups of students and to make steady progress toward their achievement as a condition of remaining in the program. While the participants would have a lot of latitude in constructing a strategy that fits their particular context, that strategy would have to show how they planned to:

- Implement an examination system related to the standards developed by the National Board.
- Empower school staff to make the key decisions as to how the students will meet those standards.
- Provide curricular resources to the school staffs related to the new standards and examinations.
- Reorganize pre-service and in-service professional development programs to support the development of the skills necessary to bring all students up to the new standards.
- Reorganize the delivery of health and social services to children and their families so as to support students and the school faculties.

- Deploy advanced technologies to support the learning of students in and out of school.
- Restructure the organization and management of public elementary and secondary education on the principles of modern quality management, empowering school staff, reducing intermediate layers of bureaucracy and the burden of rules and regulations from the state, the board of education and the unions and holding school staff accountable for student progress.

Funds provided by this program could be used for professional development, to provide critically needed 'glue' support to weld together activities consistent with the purposes of the program, and to provide student services. But funds for direct student services could be used only for services rendered before and after the regular school day, on weekends and during vacation periods. States receiving funds under this program would have to provide relief from regulation comparable to that provided by the federal government.

Federal Programs for the Disadvantaged

- The established federal education programs for the disadvantaged need to be thoroughly overhauled to reflect an emphasis on results for the students rather than compliance with the regulations. A national commission on Chapter 1, the largest of these programs, chaired by David Hornbeck, has designed a radically new version of this legislation, with the active participation of many of the advocacy groups. Other groups have been similarly engaged. We think the new administration should quickly endorse the work of the national commission and introduce its proposals early next year. It is unlikely that this legislation will pass before the deadline — two years away — for the reauthorization of the Elementary and Secondary Education Act, but early endorsement of this new approach by the administration will send a strong signal to the Congress and will greatly affect the climate in which other parts of the act will be considered.

Public Choice, Technology, Integrated Health and Human Services, Curriculum Resources, High Performance Management, Professional Development and Research and Development

- The restructuring of the schools that we envision is not likely to succeed unless the schools have a lot of information about how to do it and real assistance in getting it done. The areas in which this help is needed are suggested by the heading for this section. One of the most cost-effective things the federal government could do is to provide support for research, development and technical assistance to the schools on these topics. The new Secretary of Education should be directed to propose a strategy for doing just that, on a scale sufficient to the need. Existing programs of research, development and assistance should be examined as possible sources of funds for these purposes. Professional development is a special case. To build the restructured system will require an enormous amount of professional development and the time in which professionals can take advantage of such a resource. Both cost a lot of money. One of the priorities for the new education secretary should be the development of strategies for dealing with these problems. But here, as elsewhere, there are some existing programs in the Department of Education whose funds can be redirected for this purpose, programs that are not currently informed by the goals that we have spelled out. Much of what we have in mind here can be accomplished through the reauthorization of the Office of Educational Research and Improvement.

Early Childhood Education

- The President-Elect has committed himself to a great expansion in the funding of Head Start. We agree. But the design of the program should be changed to reflect several important requirements. The quality of professional preparation for the people who staff these programs is very low and there are no standards that apply to their employment. The same kind of standard setting we have called for in the rest of this plan should inform the approach to this program. Early childhood education should be combined with quality day care to provide wrap-around programs that enable working parents to drop off their children at the beginning of the work day and pick them up at the end. Full funding for the very poor should be combined with matching funds to extend the tuition paid by middle-class parents to make sure that these programs are not officially segregated by income. The growth of the program should be phased in, rather than done all at once, so that quality problems can be addressed along the way, based on developing examples of best practice. These and other related issues need to be addressed, in our judgment, before the new administration commits itself on the specific form of increased support for Head Start.

Putting the Package Together

Here we remind the reader of what we said as the beginning about the packaging of this agenda. We propose that the ideas just described be assembled into four high priority *packages:*

1. *The first would use the Clinton proposal for an apprenticeship system as the keystone of the strategy for putting the whole new postsecondary training system in place. It would consist of the proposal for postsecondary standards, the Collaborative Design and Development proposal, the technical assistance proposal and the postsecondary education finance proposal.*

2. *The second would combine the initiatives on dislocated workers, the rebuilt employment service and the new system of labor market boards as the Clinton administration's employment security program, built on the best practices anywhere in the world. This is the backbone of a system for assuring adult workers in our society that they need never again watch with dismay as their jobs disappear and their chances of ever getting a good job again go with them.*

3. *The third would concentrate on the overwhelming problems of our inner cities (and, at the school level, poor rural areas), combining most of the elements of the first and second packages into a special program to greatly raise the work-related skills of the people trapped in the core of our great cities.*

4. *The fourth would enable the new administration to take advantage of legislation on which Congress has already been working to advance the elementary and secondary reform agenda. It would combine the successor to HR 4323 and S2 (incorporating the systemic reform agenda and the board for student performance standards) with the proposal for revamping Chapter 1.*

PREPARED STATEMENT OF JAMES D. WEILL

The Children's Defense Fund (CDF) greatly appreciates the opportunity to testify here today. This committee has provided important leadership over the years in directing attention to the needs of low-income children and families.

Much of the economic debate going on in our country today centers on the deficit, and on the size and scope of the forthcoming stimulus package. These are very important concerns. Our nation needs to attain strong economic growth again. And getting control over the deficit is central to building and sustaining the long-term economic health of the nation.

Equally central to the long-term economic health of the nation, however, is meeting the needs of our children and families. Neglecting an out-of-control deficit certainly subverts our economic and social future. But neglecting the desperate needs of millions of American children just as certainly subverts our economic and social future. Ill-fed, undereducated, unhealthy and increasingly alienated generations of future workers, parents and voters will not grow the economy, sustain Social Security's intergenerational promise, maintain a strong defense or nurture our democracy no matter how small the deficit is.

Therefore, our nation must take the steps needed to assure that no child is left behind. We must focus considerably more resources on families and children so that our nation remains strong and competitive in the 21st century.

Child Poverty

The American dream is collapsing all around America for millions of families, youths, and children in all races and classes. We are in danger of becoming two nations -- one of first world privilege and another of Third World deprivation -- struggling against increasing odds to co-exist peacefully as a shrinking middle class barely holds on. While the middle class has lost ground, more children and families have fallen into poverty and the poor have become poorer, more desperate, hungry, homeless, and hopeless.

Today children, and especially very young children, are the poorest Americans. Children are almost twice as likely as any other age group to be poor. More than 14 million of our children -- one in five children (and one in four preschoolers) -- are poor.

As recently as the late 1960s, poverty rates for children were much closer to those for working age adults and lower than those for the elderly. This pattern was reversed in the 1970s and 1980s, with children becoming by far the poorest of all Americans. As Senator Moynihan has said, we may be the first society in history to have made children its poorest members. This is a unique act of self-destruction.There are more poor children in America today (14,341,000) than in any year since 1965, despite the 88 percent real growth in our Gross National Product (GNP) during this period. Moreover, child poverty is a pervasive national problem, not an isolated one. Contrary to popular myth, a majority of poor children are not black; a majority live in working families; and a majority live outside inner cities in small town, rural, and suburban America.

There are more poor children in rich America than there are citizens in famine-stricken Somalia; more in Los Angeles and New York City than there are in the "developing" nation of Botswana. It is a great human and moral tragedy that thousands of children and adults have starved to death in poor, war-torn Somalia with a per-capita income of less than $200 a year and an estimated GNP of $1.6 billion. It is a human and moral travesty that over 14.3 million American children are poor, and that an estimated 5 million go hungry in a nation with a per-capita income of $19,700 and a Gross Domestic Product of $5.9 trillion.

Child Poverty And Economic Cycles

Our nation's astronomical child poverty rates are not just the result of the recession and will not be solved just by economic growth. They are also the result of falling wages, growing numbers of part-time and temporary jobs, growing family instability, and a host of other structural problems that have unfortunately survived recent recessions and lingered during growth periods.

Despite uninterrupted economic growth from the end of 1982 through 1989, the number of children in poverty increased by more than 2.2 million in only a decade (from 1979 to 1989). In earlier eras some children fell into poverty during recessions, but larger numbers of them escaped poverty during recoveries. In recent years, however, children have been hurt more by recessions and have become less and less likely to bounce back during periods of economic recovery. This switch in the impact of U.S. economic cycles has devastated families with children.

The recessions of the 1970s were much deeper than the single recession of the 1960s, pushing children into poverty at a rate of more than half a million per recession year. The impact of recessions on children grew even worse in the 1980s, adding an average of 884,000 children annually to the ranks of the poor. And during the 1990-1991 recess ion's low growth period, more than 875,000 children were added to the ranks of the poor each year.

In turn, economic recoveries have lost their ability to rescue children from poverty. During the 1960s, growth periods lifted more than 900,000 children annually out of poverty. In the 1970s and 1980s this rate dropped to fewer than 300,000 annually. Indeed, in 1989, the last year of the economic recovery before the recession, the number of children in poverty actually grew.

In short, the impact of full economic cycles of recession and recovery has changed. Child poverty rates now ratchet upwards rather than fall down with each successive full cycle. If the pattern of the 1980s holds true in the 1990s, nearly one quarter of the nation's children will be poor at the end of the century.

The Costs Of Child Poverty -- For Children And The Nation

Our astronomical rates of child poverty are a tragedy not just for the children involved, but for the nation as a whole. Poor children disproportionately suffer an erosion of their health, their abilities, their hopes, and their spirits. The nation suffers an erosion of its future.

For some children, the consequences of poverty can be deadly. Several years ago the Maine Health Bureau found that poor children were more than three times as likely as other children to die during childhood, and estimated that 10,000 children die from poverty in the United States each year. The vast majority of poor children do not die from poverty, but their health and development and eventual capabilities and productivity as workers, parents, and citizens often are damaged by the deprivations of growing up poor.

From the earliest years of life to the verge of adulthood, poverty places its child victims at higher risk of a host of problems, many of which will follow them throughout their lives. Prematurity, low birth weight, birth defects, infant death and other bad health outcomes are linked to low income, low educational level, low occupational status, and other indicators of social and economic disadvantage. Poverty is also often associated with significant developmental limitations, with growth retardation, and with blood lead levels sufficient to place children at risk for impaired mental and physical development.

Poor children are less likely to receive key building blocks of early development -- adequate nutrition, decent medical care, a safe and secure environment, and access to early childhood development programs to supplement learning opportunities in the home. They are far more likely to be hungry and those who are hungry are more likely to suffer fatigue, dizziness, irritability, headaches, ear infections, frequent colds, unwanted weight loss, inability to concentrate, and increased school absenteeism.

Poor children are far more likely to have below-average basic academic skills and fall behind in school, to repeat grades, and to drop out of school. Girls who are poor and who have below-average basic academic skills, regardless of their race, are five and a half times more likely to have children during their teenage years than nonpoor teenagers with average or better basic skills.

Poverty also means more homelessness, more substance abuse, more crime, more violence, more racial tension, more envy, more despair and more cynicism -- a long-term economic and social disaster not just for children but for the country. In virtually every critical area of child development and healthy maturation, family poverty creates huge roadblocks to individual accomplishment, future economic self-sufficiency, and national progress.

There are profound effects on children and the nation every hour of every day:

- Every 12 seconds of the school day, an American child drops out (380,000 a year).
- Every 13 seconds, an American child is reported abused or neglected (2.7 million a year).
- Every 26 seconds, an American child runs away from home (1.2 million a year).
- About every minute, an American teenager has a baby.
- Every 9 minutes, an American child is arrested for a drug offense.
- Every 40 minutes, an American child is arrested for drunk driving.
- Every 53 minutes in our rich land, an American child dies from poverty.
- Every 3 hours, a child is murdered.

Our high child poverty rates, aside from being a moral abomination, make it far more difficult to solve a host of these and other social problems afflicting children, their families, and the nation. Child poverty is weakening our nation and subverting its future.

By many measures of children's well-being, America's performance compared with that of its allies and competitors is dismal. Our nation's rank in combating infant mortality has dropped to only 20th in the world. We are 31st in avoiding low-birthweight births. And once in school, our students fare poorly on tests of educational achievement compared with their peers in other nations. High child poverty rates play a key role in all of these lags and represent a growing threat to our future strength and economic competitiveness.

Young Families And The Economy

Much of the increase in child poverty, much of the sense of growing economic insecurity, and much of the economic turmoil of the last two decades have been concentrated among America's young families.

Young families with children -- those headed by persons under the age of 30 -- have been devastated since 1973 by an unprecedented and almost unimaginable cycle of falling incomes, increasing family disintegration, and rising poverty. In the process, the foundations for America's young families have been so thoroughly undermined that two complete generations of Americans -- today's young parents, and their small children -- are now in jeopardy.

Young families are the crucible for America's future and America's dream. Most children spend at least part of their lives -- their youngest and most developmentally vulnerable months and years -- in young families. How we treat these families therefore goes a long way toward defining what our nation as a whole will be like twenty, fifty, and even seventy- five years from now, economically, culturally and politically.

Adjusted for inflation, the median income of young families with children plunged by one-third between 1973 and 1990. This figure includes income from all sources, and the drop occurred even though many families sent a second earner into the workforce. As a result, poverty among these young families more than doubled, and by 1990 a shocking 40 percent --4 in 10 -- children in young families were poor.

The past two decades have been difficult for many other Americans as well. But older families with children have lost only a little economic ground since 1973, and families without children have enjoyed substantial income gains. In effect, the nation's economic pain has been focused most intensively on the weakest and most vulnerable among us -- young families with children.

Again, this is not a story about the recent recession, although the recession surely had a crushing impact on young families. Even comparing 1973 to 1989 -- two good economic years at the end of sustained periods of growth -- the median income of young families with children dropped by one-fourth. Then just the first few months of the recession in 1990 sent young families' incomes plummeting to new depths.

This also is not a story about teenagers. While America's teen pregnancy problem demands an urgent response, only 3 percent of the young families with children we are discussing are headed by teenagers. More than 70 percent are headed by someone aged 25 to 29. The plight of America's young families is overwhelmingly the plight of young adults who are old enough to assume the responsibilities of parenthood and adulthood, but for whom the road often is blocked.

Finally and most importantly, this is not simply a story about minority children, or children in single-parent families, or children whose parents dropped out of high school.

Huge income losses have affected virtually every group of young families with children: white, black and Latino; married- couple and single-parent; and those headed by high school graduates as well as dropouts. Only young families with children headed by college graduates experienced slight income gains between 1973 and 1990.

In other words, the economic and social disaster facing young families with children has now reached virtually all of our young families. One in four white children in young families is now poor. One in five children in young married-couple families is now poor. And one in three children in families headed by a young high school graduate is now poor. Nearly three-fourths of the increase in poverty among young families since 1973 has occurred outside the nation's central cities. And poverty has grown most rapidly among young families with only one child.

Young families not only have lost income in huge amounts, but as the permanence and quality of their jobs deteriorated, they have lost fringe benefits like health insurance as well. In the decade of the 1980s the proportion of employed heads of young families with children whose employers made health insurance available by paying all or part of the cost dropped by one-fifth. And employers cut back on coverage for dependent spouses and children even more than for workers.

Because they are poorer and less likely to have adequate insurance or any insurance, fewer and fewer young pregnant women have been getting adequate prenatal care. And our falling vaccination rates and renewed epidemics of measles and other wholly preventable diseases among preschoolers are being driven not just by skyrocketing vaccine prices, but by plunging incomes in young families, eroding health insurance coverage and unraveling government programs.

Falling incomes also have devastated young families in an increasingly expensive housing market. One-third fewer young families with children were homeowners in 1991 than in 1980. Young renter families increasingly are paying astronomical shares of their meager incomes for rent. More and more are doubling up or becoming homeless -- in some surveys three-fourths of the homeless parents in this country are under age 30.

Young families are not only suffering in absolute terms. They are suffering in relative terms as well, because they are falling further and further behind their parents a generation earlier and behind the rest of the society now -- imperiling their attachment to the core work force and to mainstream values and threatening their potential to reacquire the American dream in the decades to come.

In 1973 the median income of older families with children was not quite 1 and 1/2 times that of young families with children. By 1990 it was more than double that of the young families.

There is no single cause of young families' plight. They have been pummel led by a combination of profouned changes in the American economy; the government's inadequate response to families in trouble; aned changes in the composition of young families themselves. These changes have hurt all young families with children, regardless of their family structure, race or ethnicity, or educational attainment.

Unlike members of earlier generations, young workers today no longer can be confident of finding stable jobs with decent wages, even if they get a high school diploma or spend a couple of years in college. Since 1973, slower growth in U.S. productivity and declines in blue collar employment may have made some drop in inflation-adjusted median earnings for some groups of workers inevitable. By 1991 the average wages of all nonsupervisory workers (of all ages) in the private sector fell to their lowest level since the Eisenhower Administration. But the losses have been focused disproportionately on young workers.

The median annual earnings of heaeds of young families with children fell a staggering 44 percent from 1973 to 1990. In other words, in the span of less than a generation this nation nearly halved the earnings of young household heads with children. These dramatic earnings losses occurred across-the- board. Young white families with children were hit as hared as young Latino families: the median earnings of both groups fell by two-fifths. College graduates as well as high school graduates and dropouts lost big chunks of income. But the drop in median earnings for high school edropouts and for young black family heads has been particularly devastating -- in each case more than two-thirds.

The erosion in pay levels (due in part to the declining value of the minimum wage) combineed with the growth of temporary or part-time and part-year jobs to put a triple whammy on young workers: far lower annual earnings; less secure employment; and less access to health insurance and other employer-provided benefits.

The huge drop in earnings among America's young workers has been partially obscured by the almost Herculean work effort of young parents. Many young married-couple families have tried to compensate for lower wages by sending a second worker into the work force. These second earners have softened (but not eliminated) the economic blow. But the growing number of young parents working longer hours or coping with two jobs has placed families with children under tremendous stress and generated new offsetting costs, especially for child care. Many families, moreover, have two jobs that together provide less security and less support and less access to health care than one good job did a generation ago.

In addition, this two-earner strategy is totally unavailable to the growing number of single-parent families. The growth in the number of young female-headed families with children is in part a reflection of changing values. But the economic hardships associated with falling earnings and persistent joblessness among young adults also have contributed significantly to falling marriage rates and the increasing rates of out-of-wedlock childbearing.

The capacity to support a family has a powerful impact on the marriage decisions of young people. More than two centuries ago Benjamin Franklin wrote: "The number of marriages... is greater in proportion to the ease and convenience of supporting a family. When families can be easily supported, more persons marry, aned earlier in life."

The changes of the last two decades have had a very profound impact on minority young families, especially those that are black. The median earnings of the heads of young black families with children fell 71 percent from 1973 to 1990 (from $13,860 to $4,030 in 1990 dollars). Their total family incomes from all sources fell 48 percent. The median income of these young black families is now below the federal poverty line for a family of three. In 1973 it was nearly double that poverty line. Two out of three children in young black families now are poor.

This crisis for young black families is contributing mightily to the tearing apart of the black community. Growing poverty and isolation and hopelessness in turn show up in the emergency rooms and unemployment lines and prisons and homeless shelters and neonatal intensive care wards and morgues of our cities and our suburbs and rural towns. They show up in the growing violence that destroys so many black lives. More blacks die from firearms each year in this country than died in the century's worth of despicable lynchings that followed the Civil War.

But young white families are only a step or two behind in the scope of theirec onomic depression and family disintegration. Two decades of this depression for the young have had a devastating impact on many types of families we often assume are insulated from hard times. From 1973 to 1990 the poverty rate for children living in young white families more than doubled to 27 percent.

A generation ago white or married-couple young families or those headed by high school graduates were fairly well insulated from poverty. The damage of the last two decades has cut so broadly and deeply that now one in four white children in young families, one in five children in married-couple young families, and one in three children in families headed by young high school graduates is poor.

In 1990 a child in a family headeed by a parent under age 30 was:

- twice as likely to be poor as a comparable child in 1973;
- if living with both parents, two and a half times as likely to be poor as in 1973; and
- nearly three times more likely to have been born out-of-wed lock than his counterpart two decaedes ago.

But despite the devastating suffering these numbers suggest, children in young families have been given less and less government help over the last two decades. They were getting less to begin with -- government programs are particularly stingy when it comes to helping younger adults and young children. And in the 1970s aned especially the 1980s young families saw programs that might help them cut rather than strengthened and reconf igured to adapt to new realities. As a result, government programs were less than half as effective in pulling young families out of poverty in 1990 as in 1979.

Eliminating Child Poverty And Strengthening The Nation

Child and family poverty in America in the 1990s is not inevitable. Indeed, the nation can no longer afford to have such widespread child poverty -- economically, socially, or morally.

The nation now has more than adequate resources and ability to conquer the child poverty that persists and grows amidst broader affluence. In fact, America has never been more capable economically of eliminating child poverty. Despite the picture many would sketch of a nation crippled by budget deficits and lacking the resources to tackle its fundamental problems, America's income -- as measured by the Gross National Product (GNP) -- will be at an all-time high in 1993.

The nation's success in lifting older Americans out of poverty during the past three decaedes offers compelling evidence that the nation has the knowledge and ability to edramatically reduce poverty if it chooses to. The poverty rate for persons 65 and older was slashed by nearly two-thirds between 1967 and 1989. During the 1980s, when child poverty soared, the poverty rate for older Americans steadily declined, dropping nearly one-fourth. Poverty is still too high among older Americans, but the nation's success story in combating poverty among the elderly is instructive and heartening.

For a period in the 1960s, the nation also made dramatic progress in reducing child poverty. Child poverty rates were cut in half in a single decade, falling from 27 percent in 1960 to 14 percent in 1969. Poor children were aided by a combination of robust economic growth and concerted public action. But then progress was halted during the 1970s and child poverty rates moved upwards again in the 1980s.

Four decades ago Senator Robert Taft (R-Ohio) said: "I believe that the American people feel that with the high production of which we are now capable, there is enough left over to prevent extreme hardship and maintain a minimum standard floor under subsistence, education, medical care and housing, to give to all a minimum standard of decent living and to all children a fair opportunity to get a start in life."

We must re-establish the belief of this distinguished conservative Senator as a belief and goal for all Americans. This nation is four times as wealthy as when Senator Taft spoke these words four decaedes ago. What we were capable of two generations ago we are far more capable of today. Our per capita GNP is higher than that of most of our European competitors, which have much lower child poverty rates.

America is afflicted by a poverty of riches unleavened by enough justice. Our extraordinarily high child poverty rates are not some unavoidable attribute of modern, urbanized societies or act of God. They are highly unusual and represent conscious value and political choices. Our children are two to 14 times more likely to be poor than the children of Australia, Canada, Sweden, Germany, the Netherlands, France, and the United Kingdom.

We can make other and better choices. Young families are our early warning signal, our glimpse of what will happen to all American families if we continue on our present course. That is why we must target families with children, and especially young families with our youngest and most vulnerable children, for new initiatives to give them the strong foundation they need.

We should start with those things that we all know work, where there is extraordinary support and consensus that public investments can make a difference.

Our first priority should be to guarantee full funding of an improved Head Start program that reaches all eligible children while also meeting the needs of working parents.

If we are serious about the national goal of making all children ready for school, we must make good on our long-overdue promise to give every poor preschooler a Head Start. Support for more full-day, full-year programs, key quality improvements, strong parent involvement and support, and new efforts to reach infants and toddlers when appropriate must be part of this major new Head Start initiative.

A second area where we have overwhelming consensus and the basis for quick action is on a highly visible campaign to get all American children immunized. Despite the importance of getting children off to a healthy start in life, our record in immunizing children against preventable diseases is absymal -- fewer than 60 percent of American preschool children are fully immunized, and rates are as low as 30 percent in some states. If El Salvador could suspend a civil war for three separate days every year for seven years so that children could be immunized and if China, still among the twenty poorest countries in the world, can reach an immunization rate of nearly 95%, there is no excuse for the American failure to reach all children. A sweeping U.S. immunization effort would cost little, but the long-term savings -- measured in dollars and in lives -- would be great.

Head Start and immunizations are the first places to <u>start</u> investing in the next generation, because they enjoy universal support, because they lay the groundwork for future success, and because they focus help on the youngest and neediest children. But there are many other cost-effective ways that we can build strong families, attack child poverty, create a workforce that is able to compete in the rapidly changing global economy, and save our nation's future.

We can ensure that our children and youth grow into healthy and productive adults by including comprehensive coverage for all children and pregnant women in any national health care reform plan.

We can provide jobs and valuable work experience for teenagers and adults with limited skills by including community revitalization and human service projects in any economic stimulus or infrastructure initiative.

We can increase training opportunities for our most disadvantaged youth by expanding the successful Job Corps program along the lines proposed in the Job Corps "50-50 Plan" and by launching new youth apprenticeship, community service and other vocational training efforts.

We can rescue families in crisis -- and thereby bolster the eventual self-sufficiency of both parents and children -- by quickly enacting the Family Preservation Act passed by the last Congress as part of the urban aid bill but vetoed.

We can ensure that parents and especially parents who work can support their families. We made a start with the Family and Medical Leave Act. Now we must move toward expansion of the Earned Income Credit; regular adjustments in the federal minimum wage; stepped up child support activity and creation of a child support assurance system; enactment of a refundable children's tax credit for hard-pressed low- and middle-income families; and welfare reform that protects needy children while fixing the anti-family, anti-work attributes of our current welfare system. Ending welfare as we know it will require as well substantial child care supports for parents, improved job training, and creation of decent jobs for parents moving away from welfare dependence.

While we address the slow, grinding violence of poverty that takes an American child's life every 53 minutes, we must also address the deadly, quick violence of guns that takes an American child's live every three hours and the lives of 25 children -- the equivalent of a classroomful -- every two days.

The deadly combination of guns, gangs, drugs, poverty, and frightened, hopeless youths is turning many of our inner cities into Vietnams of destruction and despair and our neighborhoods and schools into corridors of fear. Prison walls are bulging with the 1.1 million inmates that make us the world's leading jailor. Yet violence escalates. For thousands of children and young adults, the American dream has become a choice between prison and death. In fact, prison has become a more positive option than home and neighborhood for many youths who see no hope, no safety, no jobs, and no future outside prison walls.

A new spirit of struggle must arise across our land today to stop the neglect of children and end their poverty. Every American -- leader, parent, and citizen, led by our new president and Congress -- must struggle to reclaim our nation's soul and give our children back their hope, their sense of security, their belief in America's fairness, and their ability to dream about, envisage, and work towards a future that is attainable and real. Only in that way will we assure the nation's future economic security.

PREPARED STATEMENT OF ISSAC SHAPIRO

Mr. Chairman, thank you for the opportunity to testify here today. I am a senior research analyst at the Center on Budget and Policy Priorities. The Center is an independent, nonprofit research and analysis organization that focuses on public policy issues affecting low and moderate income Americans. My statement is based largely on a forthcoming report on policies to assist the working poor that I am coauthoring with Robert Greenstein, the Center's director.

Investments in children and in education and training will fully pay off only if improvements are also made in the returns to work for low-wage employees. The wages of the typical non-management worker have been falling for some time and the problems of the working poor have been rising. A better prepared work force can help reverse these trends, but direct steps to boost wages are needed as well. I will focus my remarks on two such steps: increases in the Earned Income Tax Credit and the minimum wage.

The Backdrop

Wage erosion has become a difficult fact of life for a large share of the American work force. After adjusting for inflation, the average wage for private, nonsupervisory workers is now at its lowest level since the mid-1960s.

The problem has become even more acute for low-wage workers. A recent Census Bureau report found that between 1979 and 1990, the proportion of full-time year-round workers paid wages too low to lift a family of four to the poverty line increased dramatically. Some 12.1 percent of full-time workers were paid wages this low in 1979; by 1990, some 18 percent earned this little. Of note, the report found that the proportion of workers with low earnings rose about two-thirds for workers of *all* educational backgrounds.[1]

Consistent with these trends, both in absolute numbers and as a share of the poverty population, the working poor remain a disturbing social problem. The combination of work and poverty is particularly prevalent among families with children.

In 1991, some 9.2 million workers were poor, 2.1 million of whom worked full-time year-round.

- A far larger number of poor people lived in families that contained at least one worker. An estimated 20 million people - some 56 percent of the poor - lived in households where someone worked during the year.
- Nearly two-thirds of all people living in poor families with children - or 15 million such people - lived in families with a worker. And 5.5 million people living in poor families with children were part of a family containing a member who worked full-time year-round.

These figures reflect substantial work effort on the part of a large segment of the poverty population. In 1990, a majority of working poor families with children contained members employed for a total of eight or more months of full-time work.[2]

The overall trend among the working poor is not encouraging; today workers are just as likely to fall into poverty as in the past. This can be shown by following the standard practice of comparing equivalent years in the economic cycle. Data from 1991, the last year for which poverty data are currently available, can be compared to data from 1980. Unemployment rates were roughly the same in both years, and the economy was in recession for at least part of each year[3]

[1] U.S. Department of Commerce, Bureau of the Census, *Workers With Low Earnings: 1964 to 1990,* Series P-60, No. 178, March 1992.

[2] Seven of every ten working poor families with children had someone employed for the equivalent of five or more months of full -time work. In these calculations, the number of hours worked by all family members is combined. The figures used in the text assume a full-time work week equates to 40 hours of employment. See U.S. Congress, House of Representatives, Committee on Ways and Means, *1992 Green Book: Background Material and Data on Programs Within thin the Jurisdiction of the Committee on Ways and Means,* May 15, 1992, p. 1282.

[3] The unemployment rate averaged 6.7 percent in 1991, a little below its 7.1 percent average in 1980. The Gross

In 1991, some 6.9 percent of all workers were poor. In 1980, 6.7 percent were poor. Similarly, in 1991, some 2.6 percent of full-time workers were poor, essentially the same as the 2.5 percent rate in 1980.

The trend among families with children is more adverse. Some 9.1 percent of families with children in which the head-of-household worked were poor in 1980. By 1991, the poverty rate among these families had risen to 11.2 percent.

The Goal: Making Work Pay

To address the problems of the working poor, there has been growing support for the notion that policies need to be devised to "make work pay." In particular, liberals and conservatives alike have coalesced around the goal that work should pay sufficiently so that individuals employed full-time should not be poor.

President Clinton, too, has expressed emphatic support for this goal. As he stated in a major policy address just last week: "We have to make sure that every American who works full-time with a child in the home does not live in poverty. If there is dignity in all work, there must be dignity for every worker."[4]

The agenda for the working poor is a full one. It includes addressing the problems of affordable child care and access to health care. It also includes helping the working poor who fail to qualify for important benefits such as food stamps because of overly stringent asset limits. A description of these and several other initiatives lies beyond the scope of my remarks. Instead, I will concentrate on reforms to two key policies that affect the returns to work: the Earned Income Tax Credit and the minimum wage. President Clinton has endorsed strengthening both policies.

Reforms To The Eic And The Minimum Wage

The goal that families with full-time workers should not be poor is generally defined as meaning that families with a worker employed full-time at the minimum wage should be able to escape poverty, once the benefits provided under the federal Earned Income Tax Credit are counted.

The Earned Income Tax Credit has become one of the most important government supports for poor workers. In 1992, nearly 14 million families received EIC benefits totaling $11.4 billion.

An important feature of the EIC is that it is refundable. This means that to the extent a family's EIC benefit exceeds its federal income tax liability, the IRS send the family a check for the difference. Since the working poor usually do not owe federal income tax, nonrefundable tax credits are of little or no benefit to them.

The EIC is popular across the political spectrum. One reason for this is that the credit is considered strongly "pro-work." Families without a working parent do not qualify for it. Moreover, unlike welfare benefits, which fall sharply as earnings rise and thereby discourage work, EIC benefits increase with each additional dollar earned by the very poor. Consequently, the EIC strengthens the incentive to work for those working little or not all.

Another feature accounting for the credit's popularity is that it is considered "pro-family." It is provided only to parents who live with their children more than half the year. Absent parents are not eligible.

Under the basic EIC, in 1993, a family with one child will receive a credit of 18.5 cents for each dollar of its first $7,750 in earnings. When a family's earnings equal $7,750, a family with one child will qualify for the maximum credit of $1,4M. The credit remains at this maximum level until a family's earnings surpass $12,200. At that point the benefit begins to be phased out; once a family's income reaches $23,050, the credit falls to zero. There is a second, slightly larger, credit level for families with two or more children.

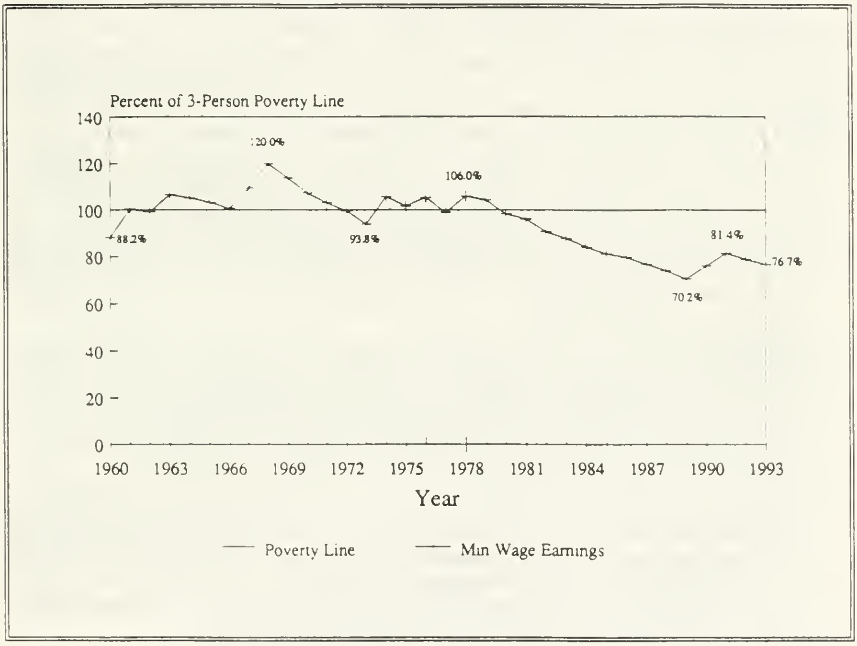
Domestic Product, the basic measure of the size of the economy, declined 0.7 percent in 1991, very close to its 1980 decline of 0.5 percent.

[4] Remarks by the President to the National Governors Association Winter Session, February 2, 1993.

The EIC was expanded sharply in 1990; this latest expansion is now phasing in and will take full effect in tax year 1994. In that year, the maximum credit will rise to 23 percent of earnings for families with one child and 25 percent for families with two or more children.[5]

While the minimum wage was also raised recently, it fared far less well than the EIC during the 1980s. The minimum wage remained at $3.35 an hour from January 1981 through March 1990; during this period, the cost of living rose 48 percent. Legislation enacted in 1989 raised the wage floor in two steps - in April 1990 and April 1991 - to its current level of $4.25 an hour. These increases made up less than half of the ground lost to inflation during the 1980s. (See Figure 1.)

Figure 1
Minimum Wage vs. Poverty Line for a Family of Three
(Earner Works Full-Time Year-Round)



As a result, the value of the minimum wage remains well below its historic level.

- The minimum wage is below its traditional level of purchasing power. Currently, the minimum wage is 22 percent lower than its average during the 1970s, after adjusting for inflation[6] If the value of the minimum wage were to have the same purchasing power in 1993 as it averaged in the 1970s, it would need to be $5.42 an hour.

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[5] The expansion enacted in 1990 was not a pure increase in assistance to the working poor. In part, the expansion was designed to offset other tax provisions of the 1990 deficit reduction package (such as increased gasoline taxes) that took a larger share of income from the poor than from the middle class or the wealthy.

[6] To determine the inflation-adjusted value of the minimum wage in 1993, an inflation rate of 3.0 percent was assumed for 1993. This is the most recent inflation rate projection issued by the Congressional Budget Office. These data were adjusted using the government's inflation indicator called the CPI-U-X.

- In the 1960s and 1970s, full-time year-round work at the minimum wage usually lifted a family of three above the poverty line. By contrast, in 1993, full-time year-round minimum wage earnings will leave a family of three $2,700 - or 23 percent - below the estimated three-person poverty line.

The minimum wage is now so low that a family of three with a full-time minimum wage worker remains below the poverty line - even when EIC benefits are added. This is seen by comparing the combined value of full-time year-round minimum wage earnings and EIC benefits, minus payroll taxes, to the poverty line.

- In 1993, full-time minimum wage earnings plus EIC benefits, minus payroll taxes, will leave a family of three $1,850 below the poverty line. [7] (Minimum wage earnings of $8,840 plus EIC benefits of $1,511 minus payroll taxes of $676 totals a net income of $9,675. This compares to the estimated three-person poverty line in 1993 of $11,523.)
- Since the poverty line rises with family size, the degree to which full- time earnings and EIC benefits fall short of the poverty line grows as family size increases. Full-time minimum wage earnings plus EIC benefits, minus payroll taxes, leaves a family of four some $5,100 below the poverty line in 1993.

If the combination of minimum wage earnings plus the Earned Income Tax Credit is to lift families out of poverty, these policies need strengthening. Moreover, it is imperative that policy reforms not rely too heavily on one policy instead of the other. The two policies are best viewed as complementary approaches, for several reasons.

- *Cost*. The cost of the EIC expansion necessary to meet the goal that families with full-time workers escape poverty is exceptionally sensitive to the value of the minimum wage. Without some increase in the minimum wage, the cost of the EIC expansion to the government is likely to be several billion dollars larger than otherwise. The costs of the minimum wage expansion are borne by the private, rather than the public, sector (and by those who benefit from the goods produced by minimum wage workers).
- *Targeting*. Compared to the minimum wage, the EIC is better targeted to the working poor and the near-poor, and also can be adjusted by the number of children in the family. At the same time, the minimum wage benefits poor single individuals and childless couples while the EIC does not. In addition, the minimum wage is relevant to most of the working poor. Among poor workers, most do have earnings at or near the minimum wage.[8]
- *Marginal tax rates*. Any expansion in the EIC would further increase the already high marginal tax rates in the income range over which the EIC is phased down. Even under current law, these marginal tax rates can exceed 50 percent. (That is, for each additional dollar of earnings, more than 50 cents is lost due to taxes or decreased benefits.) Since the minimum wage does not phase down as income rises, a higher minimum wage does not raise marginal tax rates.

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[7] As noted, the full effect of the 1990 EIC expansions will not be felt until tax year 1994. But under current law, full-time minimum wage earnings will still fall $1,660 below the poverty line for a family of three in 1994 when the EIC is added and payroll taxes are subtracted. The fall in the purchasing power of the minimum wage from 1993 to 1994 (if it remains at $4.25 an hour) nearly offsets the effect of the expansion in the EIC.

[8] Since the minimum wage assists all low-wage workers, whether or not they live in households with low incomes, it has been criticized as an inefficient mechanism for assisting the working poor. The majority of minimum wage workers are not poor.

At the same time, the level of the minimum wage is important to the working poor. Data from the Congressional Budget Office indicate that more than *half* of workers in poverty earn wages at or near the minimum wages.?? In 1987, some 57 percent of poor workers had earnings at or near the minimum wage, earning $4.35 an hour or less. It turns out that $4.35 an hour in 1987 matched the figure that the minimum wage was at in the 1960s and 1970s, after adjusting for inflation.

In addition, the increased earnings might also be of great use to some workers in moderate income families who are not officially poor, whether the example may be a young worker saving for college or perhaps a family's second earner attempting to supplement the family's squeezed standard of living.

- *Timing of payments.* More than 99 percent of EIC recipients receive the credit in one annual lump sum payment. An advance payment system is in place that enables eligible workers to receive their EIC through their regular paychecks, but this system does not function well and will be difficult to improve. The minimum wage delivers the income on a more timely basis; its benefits are received automatically in each paycheck.

In short, the strengths of the two policies complement each other. The EIC is better-targeted while the minimum wage delivers its benefits on a more timely basis without raising marginal tax rates. If the EIC is relied upon too heavily, the public costs are likely to be very high, but a combination approach results in the sharing of costs between the public and private sectors.

While expanding the EIC has received widespread, bipartisan support in policy circles, expansions to the minimum wage have proven more controversial.

The potential effect of a minimum wage increase on employment has been the principal argument raised in opposition to such an increase. The argument is made that a higher minimum wage would price a large number of workers out of the labor market. The effects are likely to be particularly harsh for teenagers, it is argued, since such a large proportion of young workers have earnings at the minimum wage and their jobs are among the most marginal.

While the potential employment effects of a minimum wage increase surely need to be considered, the weight of the empirical evidence suggests that the effects are likely to be modest. During the 1960s and the 1970s, a series of studies examined the relationship between employment opportunities and the minimum wage. Economists Charles Brown, Curtis Gilroy, and Andrew Kohen reviewed these studies for the federal Minimum Wage Study Commission established in the late 1970s. They also conducted their own study, based on a reformulation and an update of the earlier work. At the time it was issued in the early 1980s, their study was considered the most exhaustive and thorough study of the employment effects of the minimum wage.

Brown and his colleagues found a 10 percent increase in the minimum wage to be associated with a one percent decrease in the employment of teenagers and a one-quarter of one percent decrease in the employment of young adults (20 to 24 year olds). The economists found no strong evidence of any job loss for adults 25 and over.[9]

This study was based on labor market data from 1954 to 1979. Since then, labor markets - especially labor markets for young workers - have changed. The study conducted by Brown, Gilroy, and Kohen has been updated with information through 1986 and refined. The update, conducted with Brown's guidance, found a more modest effect on teenage employment - that a 10 percent increase in the minimum wage was associated with a decrease of six-tenths of one percent in teenage employment[10] In addition, the study found no significant relationship between the level of the minimum wage and the level of employment of adults aged 20 to 24t.

Moreover, studies by some of the nation's leading labor economists of the impact of the increases in the minimum wage in April 1990 and April 1991 have found it did not reduce employment. David Card of Princeton University examined the effects of the minimum wage increases on states with differing proportions of low-wage workers. He found that the wage increases boosted incomes but did not negatively affect employment, even among teenagers. Card reported: "Comparisons of grouped and individual state data confirm that the rise in the minimum wage increased teenagers' wages. There is no evidence of corresponding losses in teenage employment."[11]

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[9] Charles Brown, Curtis Gilroy, and Andrew Kohen, 'Time-Series Evidence of the Effects of the Minimum Wage' on Youth Employment and Unemployment," *The Journal of Human Resources,* Winter 1983. Many of the estimates of large job losses made during the debate over the appropriate size of the minimum wage in the late 1980s were based on the high range of the studies from the 1960s and the 1970s, often ignoring the review and update of these studies by Brown, Gilroy, and Kohen.

[10] Alison J. Wellington, "Effect of the Minimum Wage on the Employment Status of Youths: An Update," *The Journal of Human Resources,* Winter 1991.

[11] David Card, "Using Regional Variation in Wages to Measure the Effects of the Federal Minimum Wage," *In-*

Another notable study of the impact of the recent increases in the minimum wage was conducted by Lawrence Katz and Alan Krueger. (Katz was then at Harvard University; he is now chief economist of the U.S. Department of Labor.

Krueger is a Professor at Princeton University.) Their findings suggest that the employment effects of the recent minimum wage increases, if anything, seem to be positive rather than negative[12] Katz and Krueger also found that the minimum wage increases had no effect on inflation.

These studies do not suggest or prove that any increase in the minimum wage - no matter how large - would have only desirable effects. But the outcomes of the studies suggest that the labor market functions in a more complicated manner than has been assumed by those who have contended that virtually any rise in the minimum wage results in a significant decrease in employment levels. In particular, when the minimum wage is at especially low levels, as it is today, the employment effects of a change in the minimum wage may be modest.

Designing EIC And Minimum Wage Expansions

To strengthen the EIC, one necessary step is to establish a third EIC tier for families with three or more children[13] Family needs increase with family size. The poverty line and welfare benefits do as well. But wages do not. As a result, as the number of children in a low-wage family grows, the family falls steadily further below the poverty line - and wages become increasingly less competitive with welfare.

The implications are far-reaching. Poverty rates are much higher among larger families than smaller ones. In addition, Census data show that 60 percent of all children in working poor families live in families with three or more children.

The EIC now has two tiers - a basic benefit for a family with one child and a benefit about $160 a year higher for a family with two or more children.[14] The $160 annual increment is far smaller than the increase in the poverty line or in welfare benefits for an additional child.

A restructured EIC could include a third tier of benefits for families with three or more children. Such a proposal has received broad support from across the political spectrum. In 1991, for example, the bipartisan National Commission on Children unanimously recommended the addition of a third tier to the EIC. Other proposals have gone even farther. In 1988, Representative Thomas Petri (R- Wisconsin) proposed an EIC expansion that would have created four tiers, including one for families with four or more children.

In considering expansions to the minimum wage, decisions need to be made about both the level at which to set the minimum wage and how fast to get there. If the decision is made that the minimum wage should be significantly higher than the current level, it may be appropriate to reach that level through a series of steps over several years. Too large a one-time jump could be difficult for labor markets to absorb. The first increase should also be moderate enough that it does not interfere with a still weak economic recovery.

A second issue arises regardless of the level selected for the minimum wage - once the level is reached, should the minimum wage be indexed (that is, should it be adjusted each year in accordance with the inflation rate or with the rate of growth in the

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dustrial & Labor Relations Review, October 1992.

[12] Lawrence Katz and Alan Krueger, "The Effect of the Minimum Wage on the Fast-Food Industry," *Industrial & Labor Relations Review,* October 1992.

[13] In part, expansions to the EIC can be paid for by restructuring the credit itself. For example, the scheduled expansion in the credit for families with one child from 1993 to 1994 could be scaled back. This would improve the targeting of the credit. In addition, an EIC expansion could be coupled with the elimination of the two supplemental credits now part of the EIC - an extra credit provided to families with a child under age one and a credit given to families that incur premium costs for a health insurance policy that covers a child. Neither of these two supplemental credits represents sound policy. Their elimination would save a little more than $1 billion a year and would greatly improve the simplicity of the EIC.

[14] The gap of $160 applies to 1994, which is when the EIC expansion will be fully implemented.

wages of the average worker in the economy)? Indexing the minimum wage allows for small, steady changes in the minimum wage that labor markets should be able to absorb. If the minimum wage is not indexed, the EIC will have to be expanded further every year - to compensate for the loss in the purchasing power of the minimum wage - if the goal that families with full-time workers should not be poor is to be met.

President Clinton has endorsed indexing the value of the minimum wage. In addition, a very recent Wall Street Journal article reported that "Labor Department officials are expected to push for an increase of as much as 10% in the minimum wage, which is currently $4.25 [an hour], and then index it to inflation."[15] The article then went on to describe how business groups are gearing up to oppose this presumably large increase in the minimum wage.

The article did not include any context in which to judge the resulting value of the minimum wage. It turns out that an increase in the minimum wage of 10 percent would simply return its value to that achieved on April 1, 1991, when the minimum wage was last raised. This was the value agreed to by President Bush; he vetoed a bill requiring a higher level. More importantly, even with the 10 percent increase, the minimum wage would remain well below its traditional level of support, after adjusting for inflation. Its purchasing power would remain 16 percent below its average during the 1970s.

In any given year, increasing the minimum wage by more than 10 percent would probably be too much of a shock to the labor market. But if the minimum wage is to be restored to a level closer to its historic value, and in order to get closer to the goal that all families with full-time workers should not be poor, a real increase of more than 10 percent - spread out over several years - is appropriate.

A Fine Opportunity

The next few years could bode well for "make work pay" initiatives. President Clinton supports the goal that families with full-time workers should not be poor, and he is not alone in this.

Across the political spectrum, and among politicians and analysts alike, there is broad support for this principle. Some of the specific proposals receive widespread acclaim as well, such as expanding the Earned Income Tax Credit. Even policies such as strengthening the minimum wage, while contentious within policy circles, receive broad support from the general public. In the late 1980s, polls showed that a large majority of Republicans, Democrats, and Independents alike favored a minimum wage increase.[16]

The opportunity to accomplish a substantial part of the unfinished agenda for the working poor is at hand. Such an accomplishment is a necessary complement to strengthening policies that invest in our nation's current and future workers.

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[15] Kevin G. Salwen, "Business Groups Prepare to Square Off Against Clinton on Minimum Wage Issue," *Wall Street Journal,* February 8, p. A2.

[16] George Gallup, Jr. and Alec Gallup, "Proposal to Boost Minimum Wage has Overwhelming Public Support," June 19, 1988. The poll asked "do you favor or oppose increasing the minimum wage [from $3.35 per hour] to $5.05 per hour over the next four years?" Some 67 percent of Republicans, 85 percent of Democrats, and 74 percent of Independents responded favorably to this question.

Fully Funding WIC Would be a Good Investment and Would Contribute to Economic Stimulus as Well

The focus of this testimony is on the EIC and the minimum wage, but I would also like to discuss a policy area that the Center on Budget and Policy Priorities has focused on intently, and that is the Special Supplemental Food Program for Woemn, Infants, and Children. WIC provides nutritious foods, nutrition assessment and counseling, and health care referrals to low-income pregnant and postpartum women, infants, and children under the age of five who are determined to be at nutritional risk.

The General Accounting Office recently stsudies an array of children's programs and concluded that the WIC *had the best documental return on investment of any federal early intervention program.* The GAO concluded that each dollar invested in prenatal WIC benefits saves $2.89 in Medicaid, SSI, special education, and other health care costs within the first year afater birth — and saves $3.50 over 18 years.

Similarly, a study conducted for USDA by Mathematica Policy Research and issued in 1991 estimated that each dollar invested in prenatal WIC benefits saves between $1.92 and $4.21 in Medicaid costs during the first months after birth.

The payoff for WIC funding is a main reason why the program receives strong support among key business leaders. In March 1991, the CEOs of AT&T, BellSouth, Honeywell and Prudential testified on WIC before a hearing of the House Budget Committee that was convened solely to hear their testimony. They called for fully funding WIC by FY 1996.

There is broad bipartisan support for this goal. Last summer, for example, 87 Senators signed a letter calling for funding WIC at the level appropriate to reach full funding by FY 1996. The two Budget Committees have also embraced this goal when designing their budget resolutions. President Clinton has endorsed full funding of WIC as well, but has yet to specify when this goal should be achieved.

Expediting the fully funding of WIC merits consideration in the economic stimulus package. The best human capital programs for inclusion in a stimulus package are those that : 1)have a high spend-out rate (so they will put money into the economy quickly, increasing aggregate demand); and (2) are successful programs that represent the types of long-term investments the nation needs anyway. Thus, programs with high spend-out rates that are already part of long-term investment plans are excellent candidates for the stimulus package. The desired long-term expansion of these programs can simply be front-loaded, at no additional long-ter cost.

WIC fits this bill well. Its spend-out rate is 93 percent in the first year. Full funding of WIC also is onthe long-term agenda of the Administration and much of Congress.

PREPARED STATEMENT OF RICHARD VEDDER

JOBS AND PUBLIC POLICY

For most people, the quality of economic life is determined by the type of their job. Most income in America is generated from work, and most inequality in economic condition is traceable to differences in earnings capacity and performance between individuals. Good public policy, then, obviously must promote the development of employment opportunities both quantitatively and qualitatively.

What can be done to reduce unemployment? I am an economic historian who, along with my colleague Lowell Gallaway, have written a book, Out of Work: Unemployment and Government in Twentieth-Century America, that has just been published by Holmes and Meier of New York for the Oakland based Independent Institute. Our examination of 90 years of American employment history suggests that jobs are created quantitatively in greater amounts when market forces are allowed to operate without substantial government interference. Moreover, the greatest periods of high unemployment in American history are largely attributable to well intentioned interventions in the labor market that led to wages for workers being pushed above an equilibrium level consistent with full employment.

A Brief Employment History Of Twentieth-Century America

In our book Out of Work, Lowell Gallaway and I argue that unemployment rates are closely correlated with what we call the adjusted real wage, which is money wages adjusted both for changes in prices and productivity per worker. Figure 1 shows the actual unemployment rate by year and what our statistical model based on the adjusted real wage and its wage, price and productivity components predicts the unemployment rate to be. The model explains about 90 percent of the considerable variation in unemployment rates in the twentieth century.

The lowest unemployment rates in the 20th century occurred during the period 1900-1929, a period when federal intervention in labor markets was at a low level. The single incident of double digit unemployment, the Depression of 1921, was probably caused by the effects of rapid inflation followed by unexpectedly severe deflation. Both price movements were aided by the newly established Federal Reserve System. The Fed's failure to stabilize prices contributed importantly to the severity of the 1921 downturn. Money wages lagged behind changes in prices, and for a time real wages rose, pricing labor out of the market, and causing the downturn. We got out of the depression within two years without any federal intervention; the president, Woodrow Wilson, was immobilized with health problems and the new president, Warren Harding, was disinclined to do anything about the problem. The market solved the problems through wage adjustments and productivity advances.

The Great Depression can be explained in terms of Herbert Hoover's high wage policy, which priced labor out of the market and, additionally, contributed to the banking crisis by lowering the value of bank loans to businesses, loans that lost value as firms became financially vulnerable from paying workers above normal wages. The Smoot-Hawley tariff reduced international labor competition, contributing to higher wages and the resultant higher unemployment.

Franklin Roosevelt continued the high wage policy, as such policies as the National Industrial Recovery Act and the National Labor Relations Act contributed to wage explosions that prevented market adjustments from working normally.

The powers of labor market adjustment were best shown after World War II. In 12 months, the federal government reduced its employment by 10,000,000 - the equivalent today, in relation to the labor force, of 22 million. At the same time, the government went from running a deficit that was the equivalent today of over one trillion dollars to running a substantial budget surplus. The Keynesian economists of the era predicted massive unemployment. In reality, the annual unemployment rate never reached four percent. Markets handled the adjustment from war to peace beautifully, without special job training programs, federal infrastructure spending or the like.

The low unemployment prosperity of the late 1940s and 1950s occurred despite rather conservative monetary and fiscal policies of Presidents Truman and Eisenhower. Per capita federal public debt fell under both presidents. Federal labor market intervention actually decreased in some respects, notably with the passage of the Taft-Hartley Act. Yet unemployment never reached as high as it is today.

The 1960s prosperity was real, but the seeds of the 1970s economic malaise were sowed in that decade. One very positive development was the Kennedy tax cut, which had an important positive impact on the aggregate supply of goods and services. The following of a deliberately inflationary fiscal policy during the Kennedy, Johnson and Nixon administrations, however, led to a rise in inflationary expectations and a resultant decline in the effectiveness of countercyclical macropolicy. The attempt to reduce the adjusted real wage through deliberate inflation worked in the 1960s, but not in the 1970s, as people caught on and demanded and got bigger wage increases; lenders similarly demanded and got higher interest rates. As usual, Abraham Lincoln was right: you can fool all the people some of the time, some of the people all the time, but you cannot fool all the people all the time. The "money illusion" that explains the Phillips curve relationship came to an end as workers could no longer be fooled.

The 1982 recession was an inevitable effect of the totally unanticipated disinflation of 1981-82. For a time, money wages rose faster than prices, pushing up real wages and pricing workers out of the market. Within a year, however, without any particular intervention by the federal government, the economy turned around, with millions of new jobs formed in 1983 and 1984.

The great jobs explosion of the 1980s can be attributed in large part to moderation in wage growth and some pickup in labor productivity from the anemic experience of the 1970s. The decline in the importance of labor unions and the failure to increase the federal minimum wage for nine years are just two factors that contributed to this moderation; increasing international product and labor market competition is probably a third factor.

The 1990 recession followed a wage explosion at the beginning of 1990. Compensation per hour rose at an annual rate of eight percent in the second quarter of that year, reflecting in large part the minimum wage increase that took effect on April 1. A second minimum wage increase the following year contributed to continued upward labor cost pressures that made it difficult to get the normal market adjustments to end the downturn.

Labor Markets And The Current Economic Situation

Labor will be hired when the price is right. Like virtually anything else, more labor is hired when it becomes cheaper - the Law of Demand works in labor markets as it works in the potato market. Any government effort that tends to increase the cost of labor will tend to reduce job opportunities for American citizens.

For the past several months, the adjusted real wage has been falling. Moderate wage settlements combined with rising labor productivity have reduced labor costs per dollar of sales, which is beginning to lead to greater demand for workers. Since June, the unemployment rate has fallen at least one-fourth of the way back to its long run sustainable rate, and my reading of the statistics on wages, prices and productivity leads me to believe the unemployment rate will be down to 6.5 percent by this summer, without any intervention. Thus, without any special government policy, unemployment will have fallen in about a year at least half way back to normal from its recession high.

Proposed Clinton Economic Policies

I am somewhat concerned, however, that the recovery could be disturbed by well intentioned policies that tend to raise labor costs and thus lead to reductions in employment. Labor Secretary Reich, for example, is on record for favoring increases in the minimum wage, including tying it to changing wages in the economy. The sharp increase in the minimum wage in 1990 and 1991 contributed importantly to the rise in the adjusted real wage at that time that brought about the 1990 recession. The tragedy of minimum wage intervention is that the burden of unemployment that is generated falls largely on the young, the unskilled, and members of minority groups. The burden falls on those least able to afford it.

Other proposals discussed during the campaign or since would have similar negative effects. Banning the hiring of replacement workers in strike situations reinforces wage rigidities that collective bargaining agreements impose, rigidities that tend to prevent markets from alleviating joblessness. A training tax to finance worker training likewise would increase labor costs per dollar of sales, leading employers to reduce hiring. Extending unemployment insurance benefits further, already at a historic high with respect to duration, would raise what economists call the reservation wage, reducing job growth in months ahead. Similarly, proposed increases in taxes on income would reduce the quantity of labor supplied. It is no accident that the creation of five thousand jobs a day during the 1980s occurred at a time that changes in the tax code increased the spirit of enterprise and the work efforts of Americans. A similar job boom followed the enactment of John F. Kennedy's tax cut in the 1960s.

The new Family Leave act will increase labor costs somewhat which will have negative employment effects unless offset by reductions in wages and/or benefit levels. Such adjustments no doubt will occur in the long run. Indications that the Clinton administration will be amenable to higher tariffs is a bad sign. Economists are virtually unanimous in believing that the Smoot-Hawley tariff contributed to the Great Depression, and higher duties will tend to inflate wage settlements in protected industries, just as it did after 1930.

Most jobs are generated by small business, and the boom of jobs in the mid-1980s can be attributed in part to a favorable regulatory environment towards small business, while the sluggish job growth during the past several years can be at least partially explained by increased per worker burden associated with public policy. The Clinton administration would be well served to reverse the anti-small business bias of the Bush years, returning to the environment of the Reagan era which provided a regulatory and tax setting conducive to the hiring of labor.

It has been brought to my attention that members of the minority staff of this Committee have quantified the burden on small business of various federal tax and regulatory policies. Figure 2 shows the time trend in this burden. Note the sharp rise in the burden after George Bush took office. I do not think it is coincidental that job growth began slowing very shortly after these federally imposed costs began rising.

In the long run, the twin goals of high living standards and substantial job opportunities for American workers are incompatible objectives, unless the productivity of labor rises. High wages price workers out of markets, so getting rising wages and more employment requires output per worker to rise. President Clinton seems aware of this imperative.

Two planks of the Clinton economic program likely will be infrastructure construction and job training programs. Infrastructure investments should be made based on their expected rate of return to society. History suggests that public works programs to augment employment simply are not effective. Five years into the New Deal, and eight years into the Great Depression, massive public works expenditures had left the nation with an unemployment rate approaching 20 percent, with the modest improvement from the Depression trough being explainable by productivity growth in the private sector. Federal spending crowds out private sector spending, and there is some evidence that a shift of resources to public uses causes a drag on labor productivity. That aside, public works projects take a long time to implement, at least a year, and by the time infrastructure spending comes on line, the unemployment problem will be eliminated. Finally, how can a nation be serious about deficit reduction if it is introducing new spending programs?

Regarding job training, the evidence with respect to federal job training programs is not particularly reassuring. More important, however, there is decisive evidence that the most important variable in improving labor productivity is work experience. Male high school graduates who were year round full-time workers averaged \$16,559 a year work income in 1990 if they were 18 to 24 years old, but \$32,336 a year if they were 45 to 49 years old. Assuming workers are roughly paid according to productivity, the more experienced workers seem to be roughly twice as productive as the relatively inexperienced ones. For college graduates, the earnings growth associated with experience is still larger. The earnings gains for women tend to be somewhat less, but are still substantial.

Assuming compensation is determined by productivity considerations, the earnings data by age suggest that labor productivity for a typical male high school graduate rises by roughly three percent a year from the time the person takes his first job to the time that productivity nears a peak when the worker is in his mid-forties. Because the work experience of females is more likely to be interrupted, it is more difficult from the aggregate data to estimate the productivity growth for women, but I suspect that it probably very closely approaches that for men. The data suggest that a large proportion of the earnings gains associated with work arise from the experiences derived on the job. On the job training can be best promoted by simply getting people to work. The incentive structure is there to lead workers to want to improve their economic condition by learning on the job.

Earnings data suggest that the second great contributor to productivity advances may be education. I say "may", because employers may pay college graduates a lot more than high school graduates not simply because of the added knowledge acquired, but because college graduates tend to be smarter, more motivated, more mature, and so on. Education may be largely a screening device to find the more able members of the population. Nonetheless, to the affected individuals education has a payoff, indeed one that has grown over time.

Yet the evidence is equally clear that spending more money on public education does not lead to greater learning. Eric Hanushek of the University of Rochester has surveyed the literature on several occasions, always concluding that a majority of studies show little or no relationship between the amount of resources expended on public education and the amount learned. My own research with colleagues reinforces the Hanushek conclusion: spending on direct instruction can modestly impact on learning, but a very large proportion of school budgets go for non-instructional purposes that are unrelated or even negatively relative to learning.

The work of James Coleman showing the relative success of parochial schools, with much lower spending per pupil, reinforces Hanushek's conclusion. In short, even if you determine that there is a high potential productivity payoff to education and training, there is little evidence that, with current systems of educational delivery, spending more on the problem makes much difference. What does seem to make a difference, as Brookings Institution researcher John Chubb and Stanford Professor Terry Moe have observed, is the way schools are organized. Also critical is the sense of school community that is developed and the family environment. Kids from intact two parent homes learn more than those from single parent situations. Pouring more money into education without other reforms would be a tragic misuse of public resources.

Public Policies Creating Unemployment: The Tragedy Of Minorities

Yet public policy has failed miserably in getting persons to take that critical first job and stick with it. This is particularly true of the disadvantaged and racial minorities. As Figure 3 shows, in the year of Brown vs. Board of Education, at the beginning of the civil rights movement, 58 percent of nonwhite Americans of working age had jobs. In 1992, the proportion was less, under 56 percent. By contrast, for whites, the proportion working Increased dramatically over time, from about 55 to 62 percent. In 1954, nonwhites outworked whites, while today the reverse is true. This is so despite a myriad of civil rights laws designed to reduce racial discrimination.

Why has this happened? I would argue that federal programs designed to help low income Americans disproportionately affect minorities. These programs have reduced work effort among the poor relative to the non-poor. The true marginal tax rate on work income for black Americans is probably on average much higher than that for whites, simply because of the insidious effects of public assistance programs. A young black teenage girl with a baby considering taking welfare or a $6 an hour job will usually take welfare, since the welfare benefit package is worth as much as the work income. There is, effectively, a 100 percent tax on work. The white male graduating from college in engineering, however, will take a $30,000 job over the $12,000 welfare alternative. Our public policies discourage work effort among the minorities, preventing them from taking the first step up the job training ladder towards more productive employment.

Thus public policy has robbed the nation of productive resources; we have prevented some of our citizens from taking low paying jobs that lead to the experience and productivity gains that ultimately result in more remunerative employment. Median black family income has declined relative to white income since 1967, despite narrowing pay differentials in comparable employment, simply because of declining black labor force participation resulting from public policy.

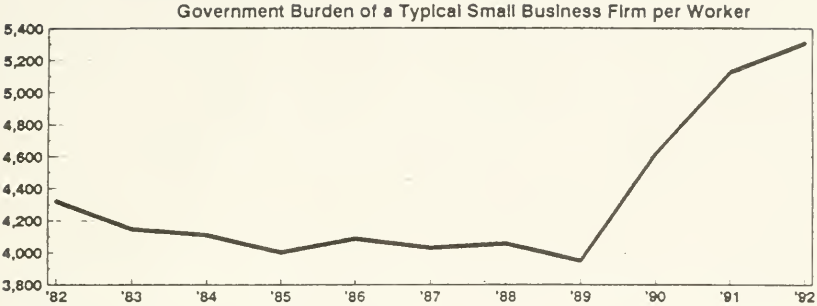
A Final Word

In short, public policy has deterred productivity growth, has promoted unemployment, and has been regressive in the most fundamental meaning of that word. Instead of re-creating old programs that have failed in the past, I hope the Clinton Administration looks to new market-based solutions to our problem of unemployment and inadequate productivity growth. Thank you.

FIGURE 1


ACTUAL VS PREDICTED UNEMPLOYMENT, 1900-1990
Predicted
Actual
Unemployment Rate
0
2
4
6
8
10
12
14
16
18
20
22
24
26
1900
1905
1910
1915
1920
1925
1930
1935
1940
1945
1950
1955
1960
1965
1970
1975
1980
1985

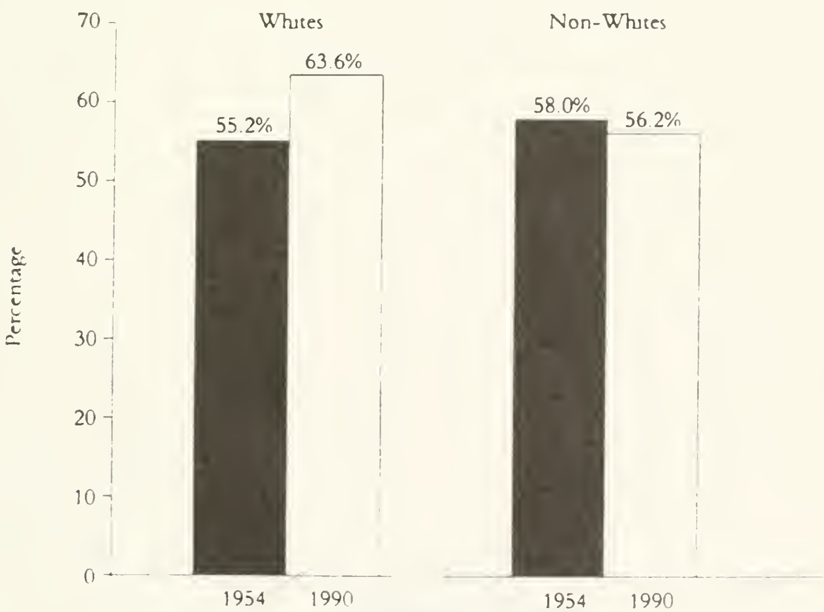
FIGURE 2



Source: JEC/GOP staff caculations.

FIGURE 3

RACIAL DIFFERENCES IN THE EMPLOYMENT-POPULATION RATIO, 1954-90



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