AUTHENTICATED
U.S. GOVERNMENT
INFORMATION
GPO

104TH CONGRESS, 1st Session | SENATE | REPORT 104–200

THE 1995 JOINT ECONOMIC REPORT

R E P O R T

ON THE

JOINT ECONOMIC COMMITTEE
CONGRESS OF THE UNITED STATES

ON THE

1995 ECONOMIC REPORT
OF THE PRESIDENT

together with

MINORITY VIEWS

DECEMBER 22, 1995.—Ordered to be printed

U.S. GOVERNMENT PRINTING OFFICE
29–010 WASHINGTON : 1995

JOINT ECONOMIC COMMITTEE

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

SENATE	HOUSE OF REPRESENTATIVES
CONNIE MACK, Florida, *Chairman*	JIM SAXTON, New Jersey, *Vice Chairman*
WILLIAM V. ROTH, JR., Delaware	THOMAS W. EWING, Illinois
LARRY E. CRAIG, Idaho	JACK QUINN, New York
ROBERT F. BENNETT, Utah	DONALD A. MANZULLO, Illinois
RICK SANTORUM, Pennsylvania	MARK SANFORD, South Carolina
ROD GRAMS, Minnesota	MAC THORNBERRY, Texas
JEFF BINGAMAN, New Mexico	FORTNEY PETE STARK, California
PAUL S. SARBANES, Maryland	DAVID R. OBEY, Wisconsin
EDWARD M. KENNEDY, Massachusetts	LEE H. HAMILTON, Indiana
CHARLES S. ROBB, Virginia	KWEISI MFUME, Maryland

ROBERT N. MOTTICE, *Executive Director*
BRIAN S. WESBURY, *Chief Economist*
LEE PRICE, *Minority Staff Director*

LETTER OF TRANSMITTAL

DECEMBER 22, 1995.

Hon. ROBERT DOLE,
Majority Leader, U.S. Senate,
Washington, DC.

DEAR MR. LEADER: Pursuant to the requirements of the Employment Act of 1946, as amended, we hereby transmit the 1995 Joint Economic Report. The analyses and conclusions of this report are to assist the several Committees of the Congress and its Members as they deal with economic issues and legislation pertaining thereto.

Sincerely,

CONNIE MACK, *Chairman.*

CONTENTS

	Page
Introduction	1
Money, Monetary Policy and The Future	4
What Is Money?	5
How Money Works	5
The Future of Monetary Policy	6
Humphrey-Hawkins and the Federal Reserve	7
Giving the Fed an Impossible Task	8
The Fed in Today's Economy	9
Monetary Tools of the Fed: Interest Rates and The Economy	10
The Mirage of Growth	12
Current Economic Data	12
The Effects of Easy Money	13
International Developments, Technology and the Case for Price Stability	14
The Impact of a Weak Dollar	16
The Domestic Economy and the Role of Government	17
Conclusion	17
Fiscal Policy	18
Freeing the Economy: A Policy for the Long Term	19
A Revolution In Constitutional Economics	23
Institutional Reforms Needed	25
Fiscal Disorder Erodes Democracy	26
Postwar Economic Policy and Economic Growth	27
Tax Reform Is Essential For Economic Growth	31
Policy Recommendations of the Chairman of the Joint Economic Committee	33
Spending Reduction Commission	34
The Flat Tax	34
Humphrey-Hawkins Reform	35
The Future	36
Getting Back to Prosperity: The Views of Vice-Chairman Saxton	36
Introduction	36
Lessons from the Reagan Expansion	37
The Burdens of Erroneous Policies	38
The Growth Deficit	40
Reduce Spending	41
Regulatory Costs	42
The Optimal Size of Government	42
The Budget	44
Reform the Tax System	45
The Problem of Political Will	46
Conclusion	47
Endnotes	47
Minority Views	49

104TH CONGRESS, 1st Session | SENATE | REPORT 104–200

THE 1995 JOINT ECONOMIC REPORT

DECEMBER 22, 1995.—Ordered to be printed

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

REPORT

together with

MINORITY VIEWS

INTRODUCTION

November 1994 brought an electoral realignment of historic proportions. After 40 years of Democrat domination of Congress, Republicans won majorities in both the House and Senate, swept into office on the promise of fundamentally changing the way government relates to the people.

In another historic development, the new majority has distinguished itself from its predecessors by actually delivering on its promises. A plan to honestly balance the budget by 2002 was passed only to be vetoed by President Clinton, and a measure to give the President line-item veto authority was adopted in both Houses. Congressional accountability bills and restrictions on unfunded mandates were passed and signed into law. The elimination and restructuring of entire departments have been suggested, and product liability reform has been passed.

Congressional Republicans are following through on the commitments they made. Republicans have faith in the talents, knowledge and abilities of the American people and reaffirm basic American values. Republicans view their majority status as not just an opportunity, but as a responsibility to effect the kind of meaningful change that voters demanded. Whether this commitment is called the Contract With America or the Republican Economic Plan, Republicans stand for a bold new vision of limited government.

For too long, politicians and bureaucrats in Washington have seized an ever-growing share of America's resources in the mistaken belief that problems are best solved by federal programs. The

real result of government's ongoing power grab has been to make it harder for families to realize the American dream.

The "1995 Economic Report of the President," released in February, promoted President Clinton's view that government spending is a positive economic force and that deficits are acceptable. His first budget echoed that credo: higher government spending, huge deficits as far as the eye could see, and an appalling unwillingness to take responsibility for its actions and even to recognize economic realities. President Clinton concluded the new congressional majority meant it would be impossible to impose yet another tax increase upon the American people, and therefore abdicated any role or duty with regard to the budget. His February plan would have generated deficits reaching over $400 billion annually in the near future, according to the Congressional Budget Office (CBO). President Clinton's February plan also did not address the crisis in Medicare, which, according to President Clinton's own trustees, will go bankrupt in 2002. In fact, President Clinton's February plan addressed none of the nation's budget problems, instead he endorsed vast increases in government regulation and spending.

After Republicans in Congress filled the void of leadership and responsibility left by President Clinton, he issued three revised budget proposals, none of which led to balance and none of which changed his priorities of higher government spending and more government programs. Senator Bill Bradley put it well when he said that Democrats prefer "the bureaucrat they know" to "the consumer they cannot control."

Instead of truly joining the debate on how to reduce the growth in government spending responsibly, the President issued another budget plan in June which purported to balance the budget. However, this plan took longer to balance the budget (ten years) than the Republican plan (seven years), assumed there would be higher economic growth and lower inflation in the years to come when compared with the Republican economic assumptions, and, perhaps most outrageously, assumed the budget would eventually balance, an assumption which CBO has categorically refuted.

President Clinton revised his June plan in July by changing the economic assumptions behind his budget, making them even more optimistic than they had been originally. He then claimed that his budget achieved balance in nine, not ten, years. CBO asserted that, while the President said his path had changed, it had in fact stayed the same: $200 billion deficits as far as the eye can see. While Republicans produced a CBO-certified balanced budget that includes tax relief for families and incentives for economic growth, President Clinton simply did not do enough to get government spending under control, instead hoping that economic assumptions would do his work for him.

However, President Clinton, undaunted, and not satisifed with releasing only three budgets in 1995, came out with a fourth version in December, which again 1) uses OMB economic assumptions, and 2) does not lead to balance by 2002 according to CBO. While those two facts are elements of any version of the 1995 Clinton Budget, the December version also contained large tax increases for corporations and job-killing regulation. In addition, because the President's fourth budget plan does not balance by 2002 according

to CBO and does not use CBO economic assumptions, that plan violates the law that the President signed in November. Instead of living up to his word, the President has let the American people down.

Republicans, on the other hand, have resolved to allow families to keep more of their own hard-earned income, and intend to improve economic growth by reducing government spending, taxes on workers and businesses, and burdensome regulations. Several studies have forecast increased annual economic growth 0.7–2.2 percentage points above the current annual trend due to provisions in the Contract With America.[1]

Cutting income taxes will allow families to keep more of their own money. The time has come to put an end to the lie that if government allows families to keep more of their own money, then politicians are giving them a hand-out. Paying less in taxes is far different from receiving money from the government. Decades of Great Society programs have apparently made government forget that the people are sovereign. By reestablishing the rightful, constitutional role of the federal government, families will reap the benefits of controlling more of their own resources.

All parents hope their children's lives will be better than their own, and that their children will have ample job opportunities. Economists have forecast that implementation of Republican economic policies, including a balanced budget, will create millions of new jobs by 2002.

Thus, Republicans are beginning to reestablish the constitutional relationship between the government and the people. It acknowledges that old-style, big-government solutions are both intellectually and financially bankrupt and have exacerbated the very problems they purported to solve. Individual responsibility, a smaller government, and lower taxes will result in a stronger economy and stronger American families.

Still, this is only a first step. The challenges of the 21st Century will demand a government far smaller than the one championed by the Clinton Administration. Government, as we have known it, has become an anachronism. Individual initiative must again become the driving force in society. Technology and economic growth offer opportunity and inclusion for all Americans. A dynamic marketplace of creative ideas—entrepreneurial, cultural, governmental, and economic—is essential to solving society's most pressing problems. As big government's increasing irrelevancy and counter-productivity become apparent, so, too, will become the inevitability of finding a better way.

In 1946, Congress passed the Employment Act, committing the federal government to promoting "maximum employment, production, and purchasing power." This was a response to the fears of many that World War II had brought only a temporary respite from the Depression. While not mandating any specific programs for achieving these goals, Congress established two advisory panels, the Council of Economic Advisers (CEA) and the Joint Economic Committee (JEC), to review economic conditions and make recommendations for achieving full employment.

---

[1] See Endnotes, p. 47.

Under the Democrat leadership that has dominated much of their history, the JEC and the CEA have supported activist approaches to economic policy, even though the best way for government to achieve "maximum employment, production, and purchasing power" is usually by staying out of the way. Even so, government has usually been loathe to cut spending because of the powerful political constituencies that develop around programs.

However, this Democrat insistence on harmful economic policies has not always been the case. In the late 1970s, under the leadership of chairman Lloyd Bentsen, a Democrat, the JEC led policy makers in Congress away from the discredited Keynesian views of fine-tuning. In its 1980 annual report, "Plugging in the Supply Side," unanimously approved by all Democrats and Republicans on the Committee, the Phillips curve tradeoff between inflation and unemployment was rejected, and a new model of growth economics that would guide the policies of the Reagan Administration was developed. In more recent years, Committee Republicans have investigated the analytical problems of the CBO and the Clinton Administration.

The Employment Act of 1946 was a mistaken response to fears born of the Depression. Because activist economic policies are almost always counterproductive, the Committee recognizes that, under Democrat rule, the policies that the JEC has advocated have often done more harm than good.

Therefore, the President, Congress and the Federal Reserve should reject any attempts to fine-tune the economy, focusing, instead, on fostering long-term economic growth. The Federal Reserve should devote itself exclusively to maintaining a stable dollar, the President should emphasize raising the long-term growth rate, and Congress should concentrate on getting America's fiscal house in order.

MONEY, MONETARY POLICY AND THE FUTURE

Money and monetary policy play a key role in both the short- and long-term development of the economy. Even so, the nature of money and the role of monetary policy are often misunderstood. Money's value depends on the faith and backing of the people whose assets it represents; thus monetary policy must focus on maintaining that faith and value. Too often, political leaders have lost sight of this fundamental goal and tried to manipulate monetary policy in hopes of fine-tuning the economy.

In the United States, mishandled monetary policy has caused erratic economic cycles, bouts of double digit inflation, a crisis in the savings and loan industry, booms and busts in land values, volatile interest rates, and a long-run decline in the value of the dollar on foreign exchange markets. This economic turmoil has resulted from misunderstanding the nature of money in the economy and a misuse of the powers of the Federal Reserve.

As the world moves into the 21st century, the United States must understand and respect the role of money. Technological advances are forging new links between manufacturers and consumers, both domestically and around the world. An integrated global economy is no longer a distant promise, but a growing reality. Money, which greases the wheels of this new economy, plays a

more crucial role than ever in facilitating smooth international transactions. In order to remain competitive, the United States must make price level stability the primary goal of its central bank. Only then can America hope to achieve long-term economic growth, rising standards of living, and job creation.

WHAT IS MONEY?

Money is a commodity. It has slightly different characteristics than other commodities because it is accepted as a medium of exchange and a store of value. It makes lives easier by lowering the cost of transactions and facilitating commerce by eliminating the necessity of barter. Falling transaction costs encourage the division of labor and enhance output and productivity. Money also allows resources to flow around the globe freely, encouraging international trade.

Understanding the nature of money as a commodity makes its role much clearer. Like any commodity, if too much of it is created, its value falls relative to other goods, and if too little is created, its value rises. Used properly, money enhances economic well-being.

HOW MONEY WORKS

Money has existed for thousands of years. Almost from the beginning, governments have blamed a significant number of problems on a "lack" of money in the economy. Sometime, individuals and politicians have called money "the root of all evil." These beliefs have led to the misuse of monetary policy and the attempt to use central banks as social policy instruments. Adam Smith, in his 1776 book, "(An Inquiry Into the Nature and Cause of) The Wealth of Nations," pointed out that many people equate more money with more purchasing power. For centuries, governments and central banks have printed excess money hoping to increase wealth, but, in fact, have only driven down the value of their money. Believing that money is the root of all evil or that money itself equals purchasing power has produced inflation, high interest rates, economic uncertainty and untold hardships the world over.

Governments have learned that when a central bank prints money and injects it into an economy, that economy accelerates. As a result, they have often turned to monetary policy to boost economic activity. As new money flows into the economy, it bids up the price of financial assets, causing interest rates to fall, which boosts the relative attractiveness of real economic goods and results in increased demand for commodities, durable goods and investment. This, in turn, leads to higher employment, incomes and consumption. This boost in economic activity, however, is artificial.

Eventually, accelerated money growth results in price distortions, inflation, and rising interest rates, which bring the artificial growth to an end. Then, as the economy readjusts its relative prices, a decline in economic activity occurs. These booms and busts explain the alternating recovery/recession phases that have marked America's economic history.

The only way to keep the economy moving, using monetary policy alone, is to continue printing greater and greater sums of new money. The result, however, is always the same: inflation accelerates and real economic activity eventually disintegrates. The Unit-

ed States suffered this experience between the late 1970s and early 1980s when double-digit inflation and severe recessions created extreme hardship. Even so, America has never experienced the kind of hyperinflation that besieged Germany following World War I, many Latin American countries during the past decades, and some Eastern European countries in recent years.

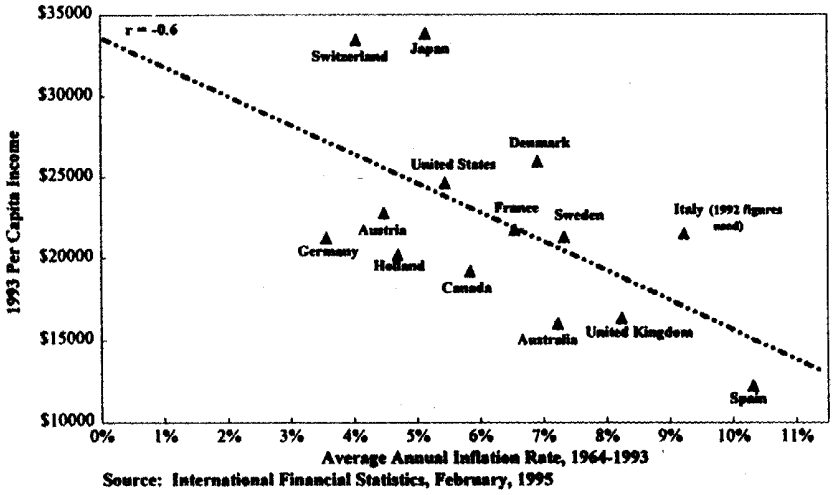
In each case, runaway inflation and the collapse in economic activity resulted from attempts to use money to create wealth. Money cannot create wealth. Wealth is created through the creativity of individuals producing goods and services that other individuals want. The flexibility of the free market is enhanced by the use of money, but money itself cannot sustain an economy.

THE FUTURE OF MONETARY POLICY

As can be seen in the chart below, those countries that have experienced the lowest inflation during the past 20 years also have the highest standards of living.

Chart 1

INFLATION LOWERS LIVING STANDARDS



Source: International Financial Statistics, February, 1995

U.S. competitiveness in the 21st century depends on a monetary policy that encourages price stability over time. This imperative has been recognized by many countries around the world. New Zealand, Germany, Great Britain, Israel and Canada have enacted legislation that focuses their central banks on price stability. These laws range from New Zealand's formal policy of keeping inflation between 0 and 2 percent, and Germany's more informal policy of price stability as the primary objective of the Bundesbank.

In the United States, a number of ideas about how to achieve price stability has been suggested. Many analysts, including Federal Reserve Chairman Alan Greenspan, have suggested that the United States move back to a gold standard so that the world has an anchor for the value of money. Only by anchoring money to

gold, these analysts suggest, will the world's economies truly realize their potential. The increased discussion of the role of gold as a tool for directing monetary policy indicates that the world-wide understanding of the role of money is becoming clearer.

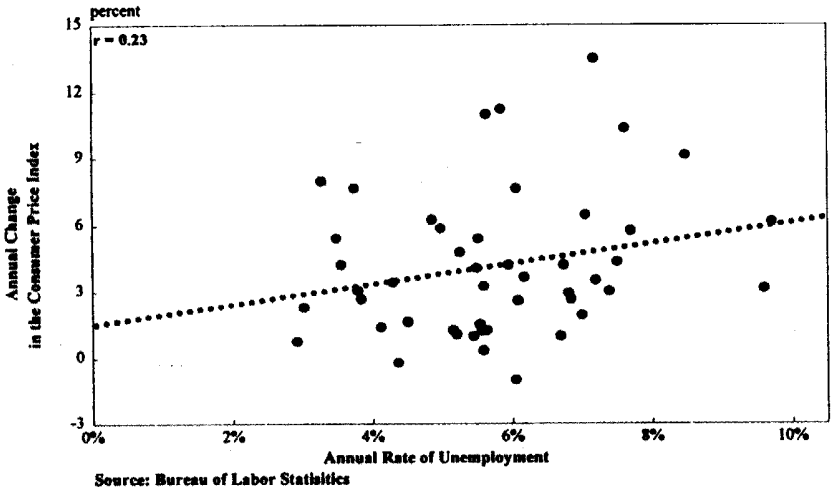
HUMPHREY-HAWKINS AND THE FEDERAL RESERVE

Sound money is as important to economic development as free markets. In 1952, Ludwig von Mises wrote, "It is impossible to grasp the meaning of the idea of sound money if one does not realize that it was devised as an instrument for the protection of civil liberties against despotic inroads on the part of governments. Ideologically it belongs in the same class with political constitutions and bills of rights." [2]

But over the last 30 years, a disturbing trend has developed in America. First, government has burdened the economy with high tax rates, government spending and regulation. They, as growth has slowed, it has turned to the Federal Reserve to boost growth. But like caffeine, the jolt to growth eventually wears off. As history has shown,the Federal Reserve cannot boost growth indefinitely without causing inflation.

For most of the past 200 years, monetary policy in the United States focused on price stability. Nonetheless, in 1978, the Democrat-controlled Congress passed the Full Employment and Balanced Growth Act (the Humphrey-Hawkins Act), which holds the Federal Reserve responsible for keeping unemployment low, telling the Fed do everything in its power to move unemployment below 3 percent, even though no serious economist today believes it possible. At the time, mainstream economic thought held that there was a tradeoff between unemployment and inflation in the economy (the so-called Phillips Curve), and that policies aimed at lowering inflation would drive up unemployment. However, this theory has not stood the test of time. Rather, as can be seen in the chart below, if any relationship between the two phenomena exists, it is not an inverse one. Multiple policy goals for the Fed have led to a confusing, inflationary bias in monetary policy, which in the end actually have caused higher unemployment.

Chart 2
UNEMPLOYMENT AND INFLATION ARE NOT INVERSELY PROPORTIONAL



Source: Bureau of Labor Statistics

GIVING THE FED AN IMPOSSIBLE TASK

To automatically blame rising unemployment on the Federal Reserve is wrong, just as it would be ridiculous to blame the resulting unemployment on the Fed if Congress pushed the minimum wage to $50 an hour. Yet, every day, government mandates, regulations and taxes increase unemployment by making it more costly for employers to hire workers. To expect the Fed to offset such government interference is both fruitless and inflationary.

In the 1960s and 1970s, following a period of success at forecasting economic activity using monetary measures, it was widely believed that the Federal Reserve could manage both unemployment and inflation. Monetary aggregates such as M1, M2 or the monetary base, were shown to be very closely linked to economic activity.

However, history shows that efforts at fine-tuning were a complete failure. While the Federal Reserve, politicians and economists focused on the cyclical ups and downs of economic activity, damaging government policies continued to erode potential growth and push unemployment higher.

Every time the Federal Reserve eased monetary policy to boost economic activity, inflation accelerated. Eventually inflation reached double-digit rates, eroding nearly one-half of Americans' purchasing power in the four years between 1978 and 1982. This clearly showed that monetary policy is not an effective tool for promoting long-term growth. Tax and regulatory cuts under President Reagan produced stronger real growth and declining unemployment, which, combined with a much less accommodative monetary

policy followed by former Federal Reserve Chairman Paul Volcker, led to a decline in inflation.

THE FED IN TODAY'S ECONOMY

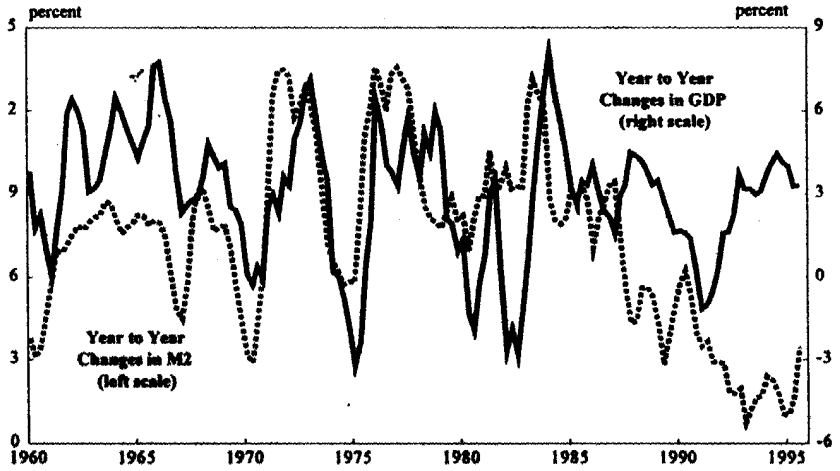
Using monetary policy to fine-tune the economy has encountered another problem as well. Changes in financial market regulations, the increased use of dollars overseas, and the proliferation of money market and mutual funds have led to a breakdown in the relationship between measures of money and the economy. In the 1970s, M2 growth influenced economic activity with a lag of approximately nine to 12 months. Today, as can be seen in the chart below, economic growth and M2 do not appear to be related at all.

While the economy has been through both a recession and a recovery, money growth has averaged 2.7 percent over the past six years, with very little movement from the average as measured by M2. In fact, M2 growth was stronger in 1989 and 1990 (averaging 4.6 percent growth) just before the recession of 1990–1991 than it was in 1991, 1992 and 1993 (averaging 2.2 percent growth), the years leading up to the stronger economic growth of the most recent recovery.

Because of the failure of monetary fine-tuning and the breakdown in the relationship between money and gross domestic product (GDP), a consensus is developing that the Federal Reserve must focus on a single goal: price stability. When prices are stable, economic growth is stronger. The best environment for improving standards of living, job opportunities and competitiveness, is price stability. Nonetheless, lower inflation does not guarantee stronger growth and lower unemployment.

Chart 3

GROSS DOMESTIC PRODUCT AND M2



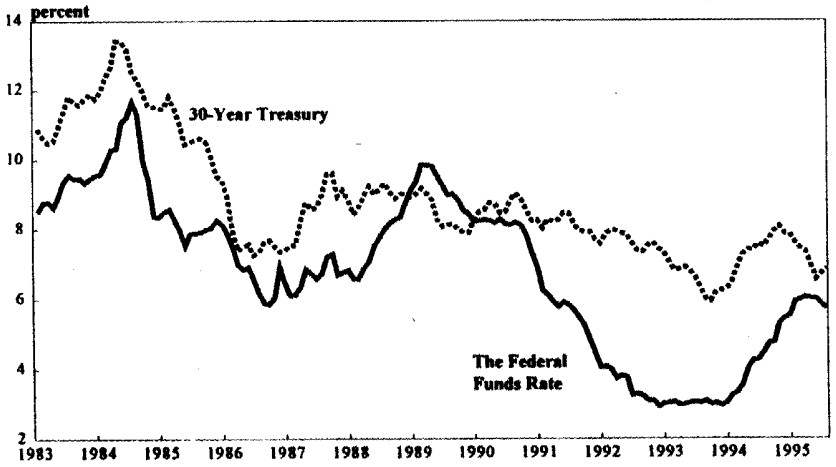
Source: Bureau of Economic Analysis; Federal Reserve Board

MONETARY TOOLS OF THE FED: INTEREST RATES AND THE ECONOMY

The Federal Reserve, by expanding or contracting its balance sheet, can add money to, or take money from, the banking system. When the Fed adds reserves to the banking system it causes the federal funds rate to decline; when it slows or contracts the growth of the reserves entering the banking system, it causes the federal funds rate to rise. The link between Federal Reserve monetary policy changes and the federal funds rate is so tight that markets and economists focus almost exclusively on interest rate changes when judging monetary policy.

When the Fed focuses on bringing inflation down, it attempts to constrict monetary growth, which causes the federal funds rate to rise. If the Fed is concerned with a slow growing economy it then begins to increase monetary growth that leads to lower interest rates. In recent years the Fed has engineered large moves in short-term interest rates. In 1988 and early 1989, the Fed was concerned about inflation, and by slowing money growth, drove the federal funds rate up to 9.75 percent (above the yield on 30-year government bonds). Then, as a recession became imminent, the Fed began to lower interest rates.

Chart 4
30-YEAR GOVERNMENT BOND YIELDS AND THE FEDERAL FUNDS RATE



Source: Federal Reserve Board

As the current recovery began, the Fed lowered the federal funds rate from 9.75 percent in early 1989 to 6 percent in early 1991. Uncertainty about the recovery and its sustainability persisted. The current recovery has been different from past recoveries in that it started slowly, with some dips in activity and then gained momentum. Normally, recoveries start out fast and then taper off. The odd nature of this recovery can be traced back to tax increases in 1991 and 1993. The tax hikes in 1991 and 1993, combined with increases

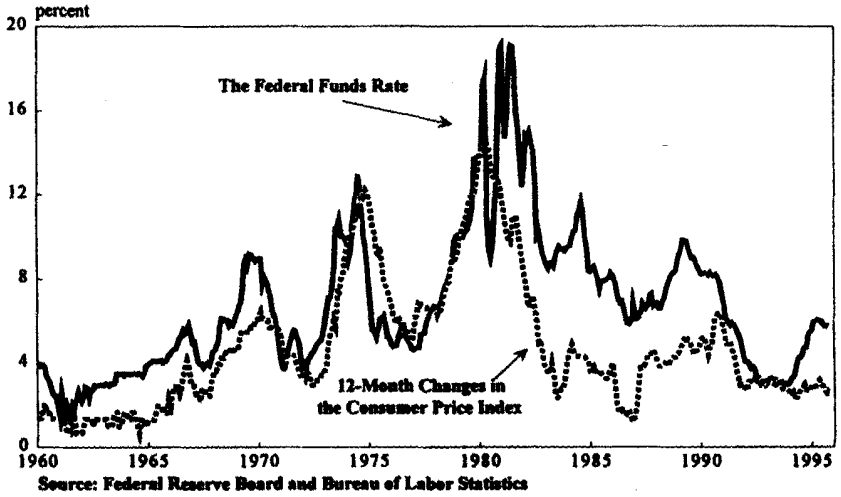
in regulation and government mandates, have shackled the economy, holding it back.

The slow start to this recovery led the Fed to push interest rates down more than necessary and hold them down far longer than normal. In the past, the Fed has increased interest rates within eight months of the end of a recession (average of past six recession/recovery phases). In the current recovery, the Fed waited 35 months after the recession trough in March 1991 to begin raising rates. In fact, the Fed continued to lower rates from 6 percent to 3 percent after the recovery had already begun.

At 3 percent, the federal funds rate was essentially equal to the rate of inflation. This meant that the real interest rate (after adjustment for inflation) was close to zero. Holding rates this low artificially boosted the economy. The last time the Fed held real interest rates at or below zero was in the late 1970s. Economic growth accelerated, but inflation also jumped, leading the Fed to raise interest rates in response. Eventually, raising rates to stop inflation caused a series of recessions.

Chart 5

THE FEDERAL FUNDS RATE AND THE CONSUMER PRICE INDEX



Source: Federal Reserve Board and Bureau of Labor Statistics

The continuation of stimulative monetary policy well into this recovery raises the concern that the economic strength between March 1991 and this summer was due to monetary policy, not to positive underlying economic fundamentals. Disappointing growth has become commonplace in the economy. Potential GDP growth is widely thought to be 2.5 percent, much lower than the 4 percent growth of the 20 years following World War II. The slowdown in potential GDP growth results from rising taxes, regulations and the size of the government relative to the economy.[3] Monetary policy alone is unable to offset government burdens and cannot boost

growth faster than potential without causing inflation. Easy money policies can only artificially boost growth for the short-term.

THE MIRAGE OF GROWTH

The artificial nature of the current recovery can be seen in data concerning family incomes and jobs. Even though the economy has been recovering, standards of living have fallen because the recovery has been weaker than normal. In 1994, the Census Bureau reported that real median family incomes were statistically unchanged after falling for four consecutive years, between 1989 and 1993. In addition, job growth in this recovery has occurred at only half the normal recovery pace. While the economy is growing, this recovery is hollow for American workers. If growth in the economy had resulted from good fiscal policies, standards of living would be rising as they did between 1983 and 1989.

In July 1995, as economic data began to point to weak economic conditions in the second quarter, the Fed responded by lowering the federal funds rate from 6 percent to 5.75 percent, the first rate reduction in two and one-half years.

CURRENT ECONOMIC DATA

In early 1995, the economy slowed sharply, causing many private forecasters to predict zero economic growth in the second quarter and some to believe that a recession had begun. Some attributed the weakness to Federal Reserve interest rate hikes during 1994, others attributed it to a buildup in inventories. Most likely, the measured weakness was caused by the Clinton tax increase passed in 1993 that forced a huge boost in tax payment during 1994. Nonetheless, the stock market continued to surge (consistently reaching all-time highs) and consumer confidence remained high. After picking-up in the summer months, the economy dropped off again in the fall with retail sales, housing starts, and industrial production all showing weakness.

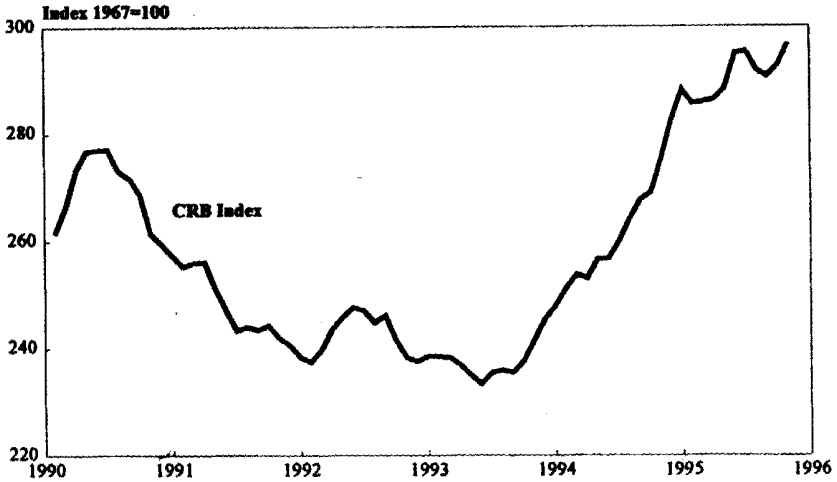
These signs of a stumbling economy are of great concern. Blaming the current stumble in the economy on the Federal Reserve misplaces much of the responsibility and continues the policy mistakes of the past. Even before the Fed reduced interest rates in July, rates were below their March 1991 levels (when the economy came out of recession), suggesting that interest rates may not be excessively high and are not the sole cause of the slowdown in economic activity during 1995.

A better explanation of the renewed weakness in economic activity suggests that when the Fed raised interest rates, and was no longer artificially stimulating economic activity, the economy began to waver under the weight of Clinton tax and regulatory hikes. The signs are clear: weak income and job growth, combined with intermittent weakness in economic activity, shows the economy is suffering from excessive government burdens. The economy needs relief from the growth-stifling policies of the Clinton Administration, not more stimulus from the Federal Reserve.

Meanwhile, there are signs that inflation is accelerating. Producer prices rose at a 2.0 percent rate in the 12 months ending November 1995. This is 1.4 percent faster than the 0.6 percent rate during 1994. Excluding food and energy, producer prices rose at a 2.6 percent annual rate in the twelve months through November of 1995, versus a 1.0 percent rate during 1994.

Other price indicators have also been rising. Gold prices remain near $390 per ounce, well above the $350 per ounce level of 1993, and commodity prices (as can be seen in the chart below) while volatile this year, are up significantly since 1993. All of these indicators suggest that the Fed created an increase in inflationary pressures during the past few years.

Chart 6
CRB INDEX



Source: Commodity Research Bureau

Higher taxes and easy money always lead to higher inflation. High taxes, regulation and government burdens cause a reduction in the potential output of goods and services and underlying weakness in economic activity. Using the Fed to boost the economy increases the output of money. More money chasing fewer goods is a clear cause of inflation.

In order to get growth moving forward and incomes rising without inflation, good fiscal policy must be followed. Instead of exclusively relying on the Fed to lower interest rates, the Congress should move forward on its plan to cut taxes and regulations and reduce the growth in government spending while the Fed focuses on price stability.

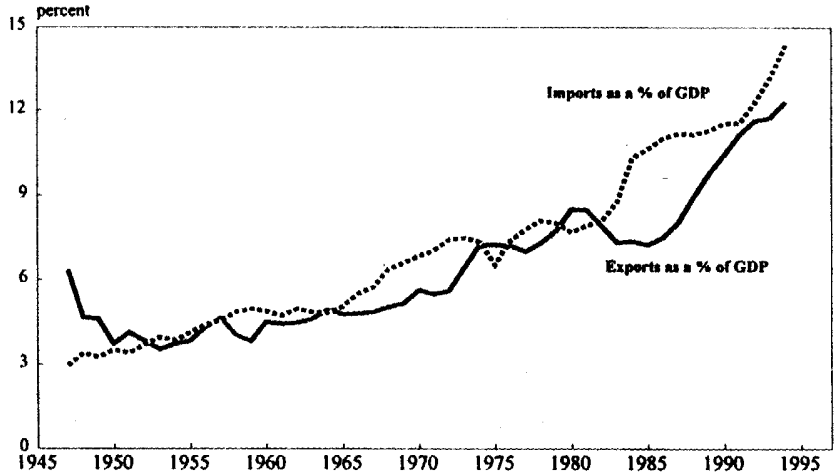
INTERNATIONAL DEVELOPMENTS, TECHNOLOGY AND THE CASE FOR PRICE STABILITY

Technological innovation and international integration are changing the economic landscape and creating greater need for a monetary policy focused primarily on price stability. First, as technology lowers the cost of information, global financial and economic integration are accelerating. Second, the pace of economic change is accelerating. As a result, the Federal Reserve must operate in an increasingly complicated and interrelated environment. Therefore, a stable unit of account is more important than ever before.

Our economy is becoming more integrated with others around the world. World trade is growing faster than world economic output and financial markets are becoming more sophisticated. The London Business School estimates that G7 trade will expand by 7.2 percent annually in inflation adjusted dollars between 1994 and 1998, while G7 real GDP will expand by only 2.7 percent annually.[4] In the United States, trade is rising dramatically as a percentage of GDP. Imports and exports have grown from near 4 percent of GDP in the 1950s to over 12 percent last year. As can be seen in the chart below, the growth of trade and its importance to our economy accelerated dramatically in the 1980s.

Chart 7

TRADE AND GROSS DOMESTIC PRODUCT

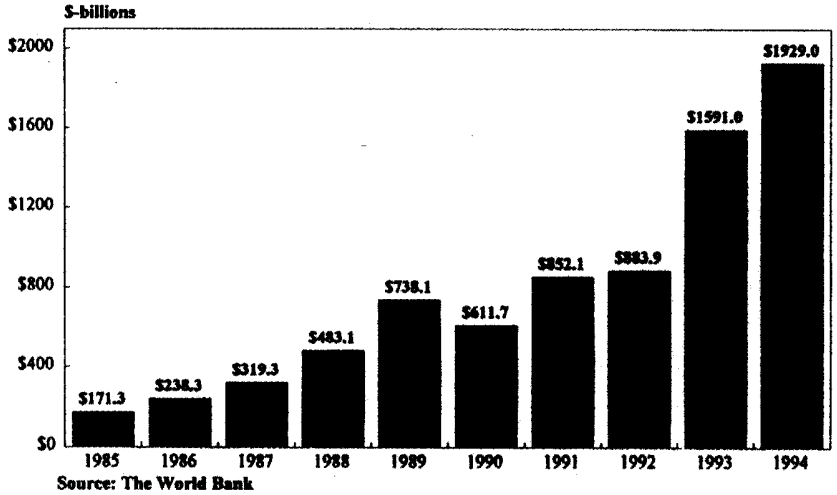


Source: U.S. Department of Commerce

The growth in world trade, while impressive, is small compared to the growth in international opportunities. The stock market capitalization for emerging markets reached $1.9 trillion in 1993, over three times the $612 billion in 1990.[5] Investors in the United States and in other countries are turning to foreign stock and bond markets for diversification and opportunity.

The explosion in world-wide investment trade can be traced to two key trends begun in the early 1980s. First, the technology boom surrounding personal computers, faxes and cellular telephones has caused a tremendous drop in the cost of information. For example, sales staffs can disseminate price lists around the world by fax faster than they could drive them across town just 20 years ago. Second, the world-wide trend toward lower taxes, privatization and free markets, begun under the leadership of President Reagan, is bearing tremendous fruit for those countries willing to follow free market policies.

Chart 8
CAPITALIZATION OF EMERGING MARKET STOCK EXCHANGES



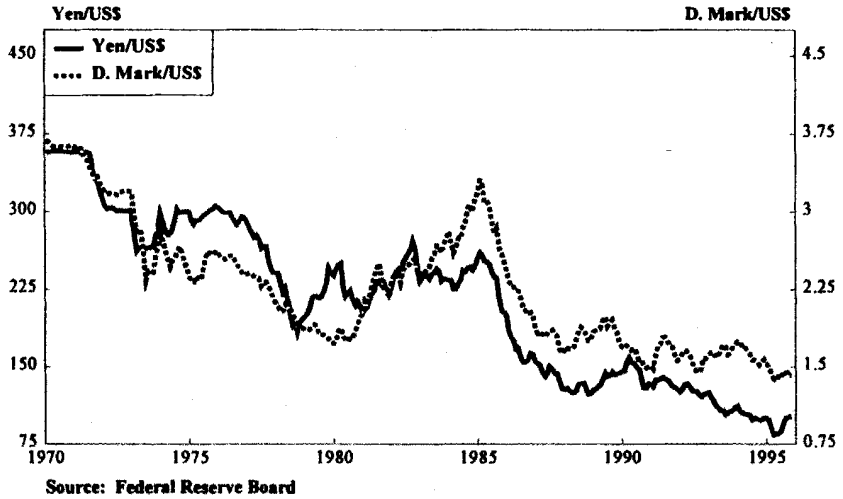
The integration of world markets and economies brings with it a need for sound and stable money. Sound money is essential to increasing the confidence of international investors. Unstable money policy leads to volatility in currency markets and weakens those economies who misuse monetary policy. Mexico is the clearest example of the damage that can be done with monetary policy.

By growing its monetary base over 20 percent during 1994,[6] the Mexican government undermined the peso. The devaluation of the peso, high inflation and soaring interest rates that the easy-peso policy caused have led to a severe contraction in the Mexican economy, a drop in the value of Mexican investments and a withdrawal of much needed foreign private capital. Highlighting the integration of world markets, American exports to Mexico have fallen by 25 percent in 1995,[7] leading to lost U.S. output and jobs.

Another complication caused by world markets is a change in the connection between money and inflation. In an integrated world economy, inflationary pressures may not be seen as quickly in the price of goods and services because prices are determined by world supply and demand. This does not mean that printing money

causes no problems. Instead, inflationary pressures are visible in a decline in the value of a currency on world markets.

Chart 9
UNITED STATES PURCHASING POWER
DOLLAR VERSUS MARK AND YEN



A decline in the value of the dollar means a reduction in U.S. purchasing power and a fall in relative income for American citizens. A decline in the value of a nation's currency is literally a drop in the ownership of world assets. As can be seen in the chart below, the dollar has weakened considerably in the past 23 years, with the exception of the Reagan growth years in the early to mid-1980s, versus the German mark and the Japanese yen following the breakdown in the Bretton Woods agreement and the closing of the gold window. The decline in the dollar translates directly to a reduction in purchasing power in world markets.

THE IMPACT OF A WEAK DOLLAR

In recent years, Americans' real incomes have stagnated as the dollar has declined. With international competition holding the prices of goods and services down, inflationary pressures have affected wages. Even though U.S. inflation has been subdued, the effect of falling incomes equates with a rise in the relative prices of goods and services. The decline in real incomes during recent years signals that inflation poses a greater problem than conventional wisdom has suggested.

In addition, with world markets becoming more important, a weak dollar increases the cost of participating in global growth. Students pay more for travel to foreign countries while investors and businesses pay higher prices for investments and face higher import costs. If America is to lead the world toward realizing its potential in the next century, the United States must defend its

purchasing power in world markets. A falling dollar lowers America's share of world output and, by definition, lower U.S. ownership in world assets. This trend must be reversed in order to defend competitiveness in the years ahead and boost standards of living.

THE DOMESTIC ECONOMY AND THE ROLE OF GOVERNMENT

As technology has lowered the cost of information and transportation, the domestic economic environment has also changed. Just-in-time inventories, computerized check-out counters, a boom in air-freight and specialized production runs have, in effect, decreased the distance between manufacturer and consumer. As a result, manufacturers respond to changes in consumption patterns much more quickly than ever before. In this environment, economic activity may behave like a traffic jam, with stopped traffic interrupted by short bursts of faster movement (known as the slinky effect).

This may explain why the economy has gone through a series of mini-cycles in recent years. The economy experienced the "triple-dip" during 1991–1993. Now, in 1995, the economy has gone through another dip in activity, which the Fed responded to by lowering interest rates. However, immediately following the Fed's action, economic data began to improve, suggesting that the Fed may have acted prematurely. Consequently, bond yields rose, indicating some heightened fear of inflation.

By reacting to uneven economic growth patterns and attempting to fine-tune the economy, the Federal Reserve could aggravate business cycles over time, leading to more volatility in economic activity and higher inflation. Fine-tuning is more dangerous today than ever before and the faster pace of economic activity creates a heightened need for the Federal Reserve to focus on the single-goal of price stability.

In addition, the government must create the best environment for economic growth. Like shrinking the number of lanes on a highway, high tax rates, an inefficient tax system, burdensome regulations and mandates constrict the ability of the economy to grow. In order to break up the traffic jam and allow growth to proceed as smoothly and quickly as possible, an environment of less taxes, less spending and less regulation is necessary.

CONCLUSION

Only by focusing monetary policy on price stability can we be assured that the United States will achieve its maximum sustainable long-term economic growth rate. Congress should replace the Humphrey-Hawkins Act with legislation that makes price stability the primary goal of the Federal Reserve.

The Fed should be asked to define price stability, tell the public how it will measure it, announce the target date for achieving price stability and explain at semi-annual hearings the economic variables that guide its progress. In this way, citizens can plan for the return to price stability that characterized the economy during most of the 19th and early 20th centuries.

It has been estimated that interest rates could tumble at least one or possibly two percentage points if markets believed that the Federal Reserve was following a credible path to price stability.[8]

Lower interest rates would make home-ownership more viable for millions of citizens who now cannot afford to buy, reduce the costs of investment and lower interest payments on the national debt. These benefits alone should be enough to move the Fed to a primary responsibility of price stability.

Price stability and the knowledge that price stability is the primary goal of the Federal Reserve are vital to maximizing economic growth and employment, minimizing interest rates and stabilizing the economy. By focusing monetary policy solely on price stability, we can guarantee a solid dollar and are create the best environment for increasing American competitiveness around the world.

FISCAL POLICY

Fiscal policy, as employed during much of the past four decades, is an anachronism. Characterized by government's taxing and spending authority to manipulate the economy in the short run, fiscal policy has proven to be largely ineffective at best, counterproductive at worst. Today's economy is complex, with economic power distributed across too wide a spectrum of individuals to be effectively manipulated by a cumbersome centralized government.

The unbroken quarter-century string of federal budget deficits is the most visible legacy of fiscal policy attempts to fine-tune the economy. Yet the most damaging result of past fiscal policy efforts has been the steady growth of government and the reduction in economic growth that has accompanied it.

Since the mid-1960s, the growth of government has exceeded the growth of nominal GDP. This has corresponded with a slowdown in real economic growth to an average of 2.6 percent from 4.0 percent before that time. Had economic growth merely continued at the pace established before the mid-1960s, the economy would be $2.66 trillion stronger today, meaning that 1994, inflation-adjusted, per-capita GDP would have been $10,300 higher.

The federal government's fiscal policy should be limited to fostering an economic climate that promotes growth. Policies that attempt to modify the behavior of economic actors in the short run, to smooth out fluctuations in the business cycle, or to engineer a distribution of income and wealth have failed in the past. Future fiscal policy should recognize these limitations and respect the decentralization of economic decision-making that enables economic growth and wealth creation to emerge from individual freedom, not government decrees.

Proper fiscal policy should be built on these three principles:

(1) Policy should focus on the long run. Attempts at short-term manipulation, or fine-tuning, are unworkable and detrimental to the economy. Fiscal policy must concentrate on creating a climate that allows the private economy the necessary freedom to achieve the highest long-term economic growth. The most successful efforts of economic policy, in the early 1960s and the early to mid-1980s, were characterized by fiscal policy focused on tax cuts and monetary policy focused on price stability.

(2) Spending must be restrained by institutional limits. Twenty-five years of federal budget deficits have created a widespread public consensus that the budget must be balanced

and the growth in spending must be reduced. Even so, elected officials face political incentives to expand the deficit and the size of government, not to shrink it. Consequently, institutional restraints on spending, particularly a balanced budget amendment to the Constitution, as well as other efforts to set limits on the discretionary ability of elected officials to spend money, are necessary.

(3) Tax policy must be fundamentally reformed. Despite periodic changes, the present tax code distorts economic decision-making and limits economic growth to a fraction of its potential. Tax reform ideas are hardly scarce. Currently popular proposals include a flat rate income tax and other consumption-based or sales taxes. From the standpoint of generating broad-based economic growth to be shared by the most citizens, the flat tax promises the least distortion and burden of any of the popular reform proposals.

FREEING THE ECONOMY: A POLICY FOR THE LONG TERM

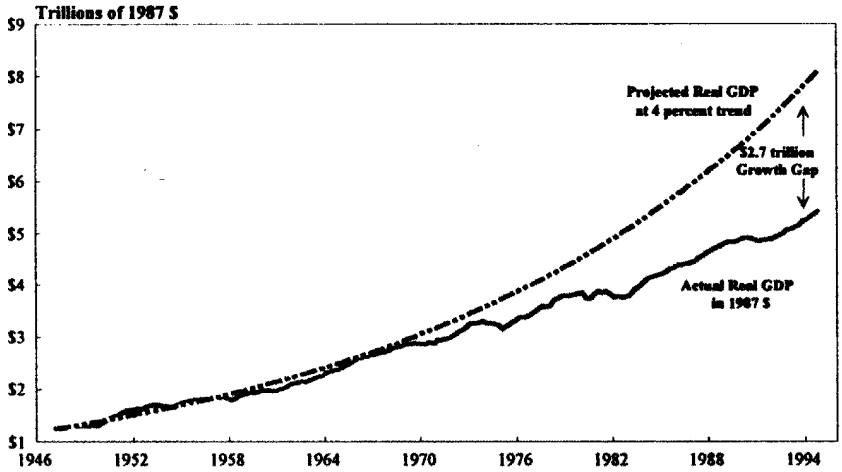
During 1994 the economy grew by a robust 4.1 percent, outperforming 1993's growth rate of 3.1 percent.[9] Yet, despite this apparently vigorous economy, Americans were uneasy and felt themselves falling behind in the struggle to improve their financial situation. November 1994 produced the largest political realignment in 40 years, confounding historical data showing that when voters approve of the economy's performance, little electoral turnover is likely.[10] How could the economy look so strong but leave so many people feeling left behind?

The key to this paradox is a decline in the standard of living. Despite gains in real GDP, real median family incomes fell by 1.9 percent in 1993, and rose a statistically insignificant 0.7 percent of 1994.[11] To put the rarity of this paradox in perspective, the last time real median family incomes fell while real GDP rose by more than 2.5 percent was 1979, during the stagflation and malaise of the Carter Administration.[12]

In trying to understand how standards of living can fall even as economic growth appears strong, it is useful to note that since 1966, the economy has under-performed its long-run growth potential to a staggering degree, as noted in Chart 1. During this time, government grew much faster than the economy. Looking at government spending plotted against total economic growth (Chart 2), two important trends become clear. First, from 1947 to the mid-1960s, government spending increased at the same rate as nominal GDP. Second, government spending began to outstrip economic growth with the imposition of the "Great Society" programs of the Kennedy-Johnson era.

Chart 1

ACTUAL VS. 4 PERCENT TREND REAL GDP GROWTH



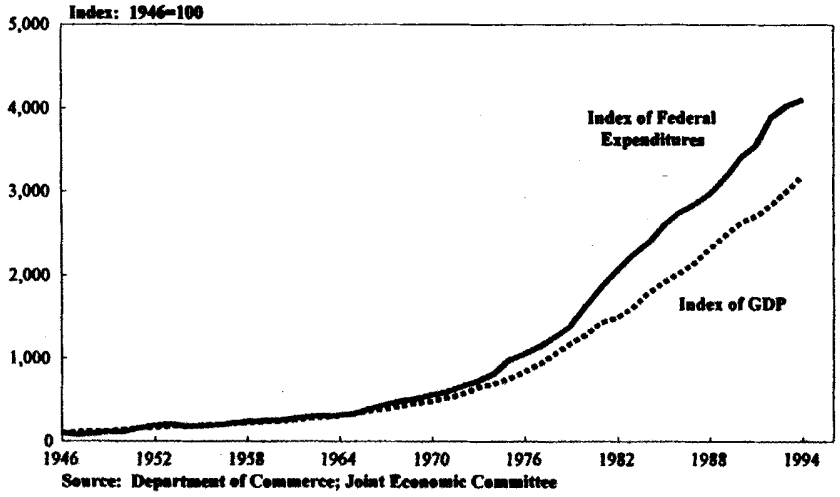
Source: Department of Commerce; Joint Economic Committee

Between 1965 and 1994, nominal GDP grew at an average rate of 8.1 percent,[13] while total federal government spending averaged 9.1 percent growth.[14] Of course, government spending did not exceed economic growth in every year: between 1982 and 1988, the economy outpaced government spending.[15] But in 1988 the trend reversed, and since then government spending has again grown faster than GDP.[16] Like federal spending, state and local government spending has also outpaced GDP.[17]

The impact on American families has been terrible. Milton Friedman has calculated the aggregate cost of direct and indirect government expenditures at a staggering 50 percent of national output.[18] It should surprise no one that the economy is showing signs of stress from dragging so much dead weight.

Chart 2

GOVERNMENT GROWS FASTER THAN THE ECONOMY

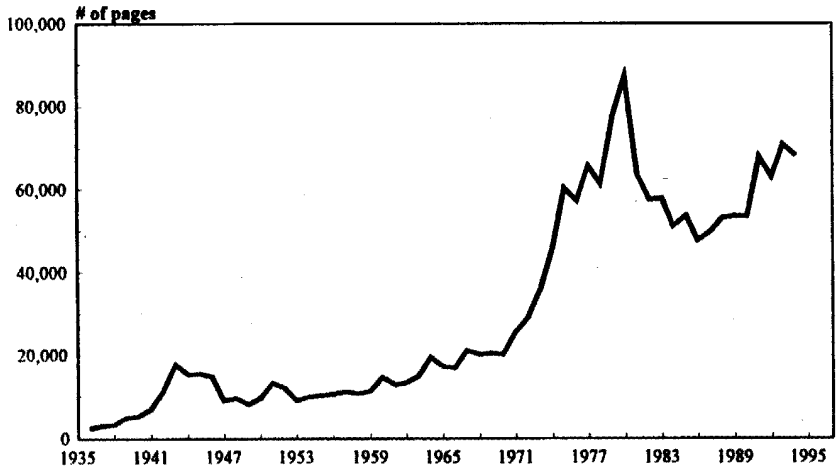


Real GDP measures the total supply of goods and services produced in the economy. Entrepreneurs will supply those goods and services only as long as there is a chance for profit. Through confiscatory taxes, onerous regulations and mandates, and other impediments to entrepreneurship, government makes profits harder to come by, and, in turn, slows economic growth and the creation of wealth. Thus, because total government spending drains resources from the marketplace, it is a worthy measure of the disincentives to wealth creation.

In addition to government spending, the assault on the American economy has been waged from a second front: government regulations pose a further impediment to the economy's potential. According to Thomas D. Hopkins of the Rochester Institute of Technology, government regulation costs the economy over $600 billion annually and, on average, costs each American household $5,000 every year.[19]

The size of the Federal Register is a good gauge of the expansion of federal regulations and of overall government growth. As noted in Chart 3, the Federal Register exploded from roughly 17,000 pages in 1965 to 87,000 pages in 1980. Regulations were brought under control in the Reagan years, and the Federal Register shrank to 53,480 pages in 1985. But it grew to nearly 70,000 pages by 1994.[20]

Chart 3
NUMBER OF PAGES IN THE FEDERAL REGISTER



Source: Marvin Zonis & Associates, Inc.; Federal Register

Since the mid-1960s, the economy has fallen farther and farther behind. Real GDP grew at an average annual rate of 4.0 percent between 1947 and 1966, but since then growth has only averaged 2.6 percent.[21] This 1.4 percentage point gap has led to a huge shortfall in real output. As suggested earlier, today's economy would be more than $2.7 trillion larger if only the economy had continued growing at the 1947–1966 rate, meaning that 1994 real per-capita GDP would have been more than $10,000 higher.[22]

While some have suggested that it is unfair or impractical to judge the growth of today's economy against the historical 4 percent average, not long ago such growth was considered entirely plausible. In January 1962, John F. Kennedy wrote in his Economic Report of the President, "Increasing our [real potential] growth rate to 4½ percent a year lies within the range of our capabilities during the 1960's."[23] In 1965, Lyndon Johnson wrote in his Economic Report of the President, "our potential [real output] is also speeding up. Estimated at 3½ percent a year during most of the 1950s, it is estimated at 4 percent in the years ahead; and sound policies can and should raise it above that."[24]

Even so, since the early 1960s, 4 percent growth has never been sustained for long. Instead, growth has cycled between periods of extreme malaise (such as the late 1970s through early 1980s) and relative vigor in which the economy came very close to the 4 percent goal (1982 through 1989).[25] Over time, the United States has consistently lost ground to the 4 percent pace, and expectations have diminished. Unless fundamental changes are made, the future looks no brighter. As Alan Greenspan and other economists have noted, the estimated noninflationary growth potential of the economy is now appreciably below 4 percent, and most likely near 2.5 percent.[26]

Even with tremendous gains in productivity and technology, real median family incomes have not made any dramatic or sustained improvement. The average manufacturing-sector work week has lengthened dramatically. Workers are working harder for little or no real improvement in their incomes.[27] Slower economic growth has impeded efforts to help the truly needy. Congress has responded counterproductively, intervening even further while claiming to provide things individuals can no longer afford for themselves. Despite massive efforts by the government to promote jobs, unemployment has risen from an average of 4.9 percent from 1948 to 1965, to an average of 6.3 percent from 1966 to today.[28]

So government programs have piled up, each promising prosperity, while Americans' standards of living have stagnated or even worsened. This slow deterioration of incomes can be difficult to see and has often been intentionally obscured for political purposes. The Federal Reserve may lower interest rates to induce artificial growth, but when rates climb and a recession occurs, "greedy" business people or indebted consumers get the blame.

Without the political will to restrain and restructure government, and without replacing the failed welfare state of the 1960s with explicit pro-growth economic policies, the United States will continue down a path of diminishing expectations. But given the courage to fulfill its mandate for change, America stands poised to reclaim the strong, long-term economic growth of its not-so-distant past. Since government has created the barriers to growth, Congress can remove them by reducing spending, balancing the budget, eliminating onerous regulations, and reducing tax rates so that the private sector can again grow faster than government, incomes can improve, and standards of living can increase for all Americans.

Shrinking government, thereby shifting resources back to businesses and families, will reduce government intrusion in the economy and in the countless family and individual decisions that it presently dictates. Shifting decisions back to states, where individuals have greater influence, and spending is limited by law, will encourage political participation. Americans want relief from the burden of excessive federal taxes that impede their efforts to save for the future.

A REVOLUTION IN CONSTITUTIONAL ECONOMICS

Recent advances in economic theory bode well for the support of this smaller government. Much of this progress is associated with two economists, both Nobel Laureates, James Buchanan and the late F. A. Hayek, who have improved society's understanding of the constitutional limits to government.

Though using different approaches, both have reached conclusions in keeping with the spirit of the Federalist philosophy embraced by most of the Founding Fathers. That spirit acknowledges human fallibility in government and supports the principles of limited government, individual freedom and equal justice under law.

James Buchanan is considered the father of modern public choice economics, an approach that applies the principles of microeconomic analysis to political decision-making. Hayek has made a number of critical contributions to both economics and political science, including an analysis of why government attempts to man-

age the economy end in failure, as well as a comprehensive analysis of constitutional issues, in "The Constitution of Liberty," and other works.

As many economists have noted, a balanced budget rule was implicitly part of an unwritten "fiscal" Constitution from the beginning. It was only after neo-Keynesian economics and its endorsement of deficit spending became accepted in the early 1960s, that deficit spending became the rule instead of the exception.

According to the neo-Keynesian view, the main object of government policy should be to balance the economy, not the budget. It was argued that government policy could "fine-tune" the economy to achieve targeted levels of economic growth, unemployment, and inflation. Although this view was later embodied in the Humphrey-Hawkins Act, the attempts to fine-tune the economy failed, and resulted in the simultaneous rise of inflation and unemployment in the late 1970s, breaking the back of the Phillips Curve.

As Hayek pointed out, the rationale of such policies as "fine-tuning" was based on the assumption that government officials possess more information than they actually have; he calls this the "pretense of knowledge." Hayek's insight harkens back to "The Federalist," in the recognition of limits in human nature shared by public officials.

Modern public choice economists have also noted the fact that the "fine-tuning" approach assumes a degree of omniscience and disinterest among public officials and their advisers that is totally unrealistic. This also legitimizes a concentration of power in government that although well-intentioned, is extremely dangerous and runs against the whole spirit of "The Federalist."

The broadly perceived failure of fine-tuning has undermined the belief in government's ability to manage the economy. However, by breaking what Buchanan has called the traditional taboo against deficit spending, this neo-Keynesian thinking left a legacy of unconstrained spending. No longer did increases in spending remain within the level set by expected revenues, but could exceed them whenever policy-makers deemed it desirable.

Without this balanced budget constraint, it is very difficult for members of representative institutions to resist pressures for additional spending. The benefits of federal spending programs are typically concentrated among program beneficiaries, while their costs are diffused among all taxpayers. This asymmetry means there is usually more intense and focused political pressure brought to bear in favor of specific programs than that reflecting the interest of all taxpayers in opposing program spending.

This modern perception of public choice economics is very similar in spirit to Madison's observations about the need for institutional safeguards to constrain the dangers of "faction." The point here is not to allege shortcomings among members of the legislature, but simply to identify the tremendous pressures for additional spending they so often face. If the current structure of our political institutions makes resistance to such pressure in the public interest more difficult, then this suggests the need for institutional reform.

INSTITUTIONAL REFORMS NEEDED

We need to restore constitutional order by making the balanced budget rule a written part of the Constitution. However, other reforms will also be needed to successfully implement any such constitutional restoration.

To achieve its constitutional purpose in limiting government, the balanced budget amendment will likely need some mechanism to at least assist the achievement of fiscal balance. The balanced budget rule as an abstract concept cannot, in and of itself, provide the appropriate budgetary decisions needed to bring federal outlays and receipts into balance by the fiscal year 2002.

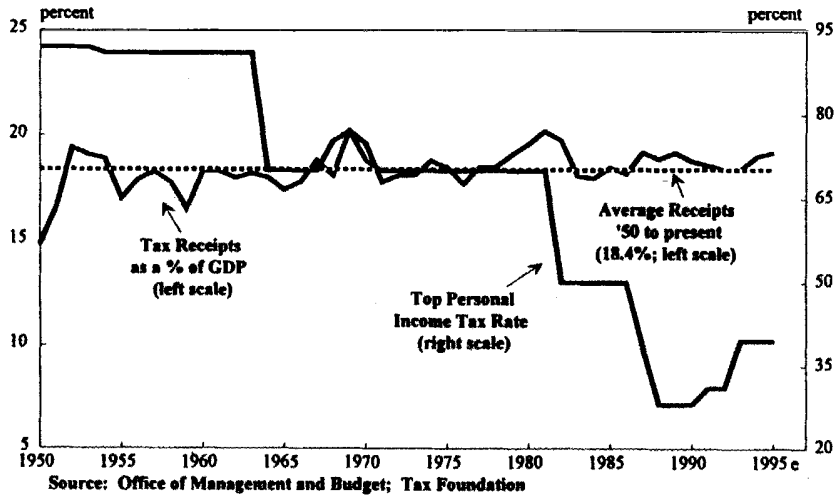
Congress, acting in the budget process, may make significant strides towards this objective, but may well fall short. An institutional safeguard is needed to backstop the political system and ensure that the job is finished. This could be the role of a spending reduction commission, modeled after the Defense Base Closure and Realignment Commission.

In the absence of this kind of institutional reform, there would be valid reasons for concern about the ability of Congress to balance the budget. As Madison pointed out, the power of coalesced factions, or special interest groups, is immense, and they will resist any effort to reduce spending growth in their favored programs. Public choice economists have also identified a kind of legislative myopia, called fiscal illusion, which is facilitated by deficit spending.

The benefits of program spending are all too visible, while the costs they impose through debt financing are much harder to identify. The legislative consideration of new spending is distorted by fiscal illusion. Fiscal illusion, via deficit finance, can be addressed by the balanced budget amendment, but the problem that spending benefits are more concentrated than their costs to taxpayers remains.

What is needed to redress the balance is a single-minded focus on the spending side of the budget. The current fiscal problem originates from the failure of spending to remain within the bounds set by revenues. Historically, revenues have oscillated around 19 percent of GDP regardless of how high tax rates were set (Chart 4). Unfortunately, spending has climbed far above this level, and is currently estimated at about 22 percent of GDP.

Chart 4
TAX RECEIPTS AND TAX RATES



Source: Office of Management and Budget; Tax Foundation

Institutional constraints such as a spending reduction commission and the line-item veto would help Congress maintain its attention on the spending side of the federal budget. Congressional actions to reduce federal spending growth would not be adversely affected in any way, but any shortfalls in achieving the glide path to a balanced budget would be covered by institutional spending constraints.

Given the intense pressures brought to bear by special interest groups and the procedural obstacles that could be invoked, some back-stopping of the normal budget process is clearly needed. Institutional constraints are essentially an insurance policy in which the American taxpayer is the beneficiary.

It is essential that the path to a balanced budget be followed by reductions in spending growth, not tax increases. Tax increases would increase both the economic and political cost of excessive government. Moreover, Joint Economic Committee research suggests that such attempts would be futile and self defeating, since in the postwar period studied, each $1 of taxes raised by Congress resulted in $1.59 of new spending. Institutional spending constraints would avoid this counterproductive path of tax increases.

FISCAL DISORDER ERODES DEMOCRACY

Unchecked deficit spending has permitted the federal government to expand far beyond any achievable political consensus. The German economist, Wilhelm Roëpke, an architect of the German post-war economic boom, predicted the effects on unchecked government in eerily prophetic terms over 30 years ago:

> The power of the state grows uncontrollably, yet, since powerful forces are at the same time eroding its structure

> and weakening the sense of community, there is less and less assurance that the administration and legislation unswervingly serve the whole nation and its long term interests. Demagogy and pressure groups turn politics into the art of finding the way of least resistance and immediate expediency or into a device for channeling other people's money to one's own group. Government, legislation, and politics of this kind are bound to forfeit public esteem and to lose their moral authority.

A balanced budget amendment that does not limit the size of government will do little to prevent this outcome, so evident in the previous Congress. The program with the federal government today is that its size and range of activities lack legitimacy because they exceed the wishes of the governed and of the taxpayers.

Moreover, big government exceeds its competence in the sense that in an attempt to do everything, it does nothing well, even those functions supported by a broad range of opinion. Thus a new fiscal regime that will constrain government will also limit the power of special interest pressures to distort the political process and undermine the legitimacy of democratic institutions. This constraint will also help the government adequately perform those functions broadly agreed upon.

POSTWAR ECONOMIC POLICY AND ECONOMIC GROWTH

A touchstone of previous Democrat administrations was that the economy's tax generating potential is essentially limitless, given careful management of monetary and fiscal policy by the government. As discussed earlier, President Kennedy's first "Economic Report of the President" committed his administration to achieving a 4,5 percent annual growth rate. Moreover, President Johnson's 1965 "Economic Report of the President" insisted that rapid economic growth was a primary goal of policy. He further indicated that "sound policies" could achieve growth rates well above 4 percent.

By contrast, most Republican Administrations have tended to be more restrained in their view of government's ability to influence the rate of growth. For example, President Eisenhower warned in his 1955 "Economic Report of the President" against economic stimulus. "The wise course for Government in 1955," he said, "is to direct its program principally toward fostering long-term economic growth rather than toward imparting an immediate upward thrust to economic activity," President Ford warned in 1976 that there was "no simple formula for single act that will quickly produce full economic health." He indicated that is would take "several years of sound policies to restore sustained, non-inflationary growth."

The Reagan Administration believed that government could positively impact economic growth. But unlike the Kennedy and Johnson Administrations, it did not believe that macroeconomic finetuning was the answer. Rather, the key to growth lay in scaling back government interference with the private market. Hence, reducing inflation, taxation and government regulation were thought to be the best means of encouraging long-term growth. As the Reagan Administration's last "Economic Report of the President"

put it: "The goal of this Administration has been to reinvigorate the private sector by limiting the size of the federal Government, improving incentives through tax cuts, improving market flexibility through deregulation, avoiding new structural rigidities, and encouraging non-inflationary monetary policy."

While the Reagan Administration saw a greater potential for economic growth, the Clinton Administration sees the economy's growth potential as severely constrained. Its latest "Economic Report of the President" argues strongly that real GDP growth will be limited to 2.5 percent per year for the foreseeable future, regardless of what actions the Administration might take.

To encourage long-term economic growth and job creation, conditions must be favorable to long-term investment and capital formation. Capital formation generates the productivity improvements that result in more production per given input of resources. Higher productivity saves resources (i.e. increases economic efficiency), increases jobs, reduces inflation and improves the well being of America's citizens.

Growth in output per worker, which contributes to increased productivity, is essential to economic growth, job creation and rising wages. Yet productivity enhancing capital was for many years taxed on the realized increases of its nominal value, much of which often reflected inflation. Such policies penalize and discourage capital investment and savings. Capital taxation policy, along with regulatory policies, including patent policy and the protection of intellectual property rights, is a major determinant of innovation in our society. For too, long, capital has been taxed heavily in order to create the appearance of punishing the rich while ignoring those who have jobs as a result of the capital.

Capital taxation is usually characterized as a concern only of the "rich," yet it most often catches middle class Americans when they sell a single major financial asset such as family homes or farms. By penalizing families in all income groups, capital gains tax policy has hurt economic growth.

The Dow Jones Industrial average has soared 165 percent over the past nine years as new markets, products, and technologies have boosted the earnings potential for the economy.[29] With this tremendous boom in asset values, capital gains tax revenues could be expected to soar. Yet they have not. Capital gains realizations have stagnated as investors have refused to sell in the face of high capital gains tax rates.

The slowdown in capital gains realizations is directly related to the misguided 1986 increase in the capital gains tax rate. The Joint Economic Committee estimates that more than $1.5 trillion in capital gains are locked-up in the economy, awaiting a reduction in the capital gains tax rate. The capital gains tax compels resources to remain in old technology industries by locking investors up in old investments. In addition, high capital gains tax rates force investors to forego flexibility in investment strategies by pushing them into tax-free investments such as pension funds, 401(k)s, IRAs and trusts.

The effective real capital gains tax rate, even at very low levels of inflation, can be higher than 100 percent because taxes are levied on both real gains and the illusory gains due to inflation.[30]

Since many foreign countries tax capital gains very slightly, if at all,[31] American companies must take drastic steps to insure a great enough return on equity investment in order to attract capital. To achieve such returns, companies in old industries are often forced to rely on cuts in payrolls and expenses to maintain an acceptable level of profitability. At the same time, new industry, which tends to add the most new jobs in the economy, must fight for capital and pay more for it.

Cutting the capital gains tax rate and then indexing it for inflation would boost economic growth, job creation, and government revenues. Lowering the capital gains tax will raise government revenue and shift locked-up capital from old to new investments. The higher revenues and investment shifting may take place immediately or may be stretched over a number of years. Nonetheless, government revenues, even with the lower tax rates, should be significantly higher than in recent years and could easily rise above currently forecasted budget numbers much as they did following the 1982 capital gains tax cut.

Because capital gains result only from the sale of assets, once investors decide to sell, the capital gains tax is a voluntary tax. While investors make decisions based on many different inputs, historical data on capital gains realizations show that tax rates are a significant factor. After the capital gains tax rate was cut to 20 percent in 1982, capital gains realizations during the four years from 1983 to 1986 totaled $763 billion, more than double the $369.2 billion in realizations during the previous five years.[32]

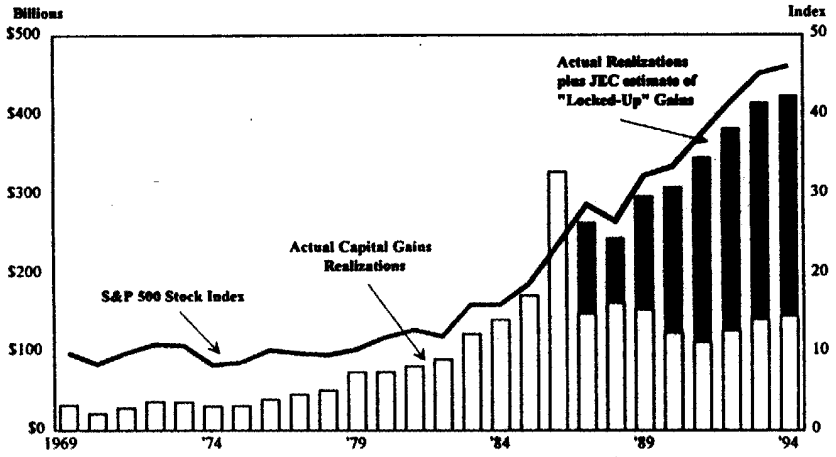
Part of this dramatic gain was due to a surge in 1986 when capital gains realizations shot up 90.6 percent as investors took gains in advance of the announced tax rate increases in 1987. Since 1987, capital gains realizations have fallen back to levels 35 percent below those of the three years before the capital gains tax increase. Even if the 1986 jump is excluded, capital gains realizations are still 11.5 percent below the pre-tax-hike levels of 1984 and 1985.[33] This decline occurred despite record-setting gains in the stock market.

In effect, the key to investment and economic growth was discarded in 1987 when the capital gains tax rate was increased. Between 1985 and 1994, the S&P 500 increased by 146 percent.[34] If capital gains realizations had merely kept pace with the S&P 500, there would have been $2.7 trillion in realizations between 1987 and 1994. Instead, using any reasonable estimate of actual realizations for 1994, there were less than $1.2 trillion.[35] This suggests that at least $1.5 trillion in capital gains realizations are locked-up or forced into inflexible tax-free investment strategies. Obviously, investors are refusing to sell in the face of punitive tax treatment.

Joint Economic Committee analysis shows the shortfall in capital gains realizations suggested by stock market gains (Chart 5). These estimates used 1985 realizations as a base, so that the artificial boost in realizations during 1986 did not lead to an overstatement of potential gains.

Chart 5

CAPITAL GAINS REALIZATION AND THE STOCK MARKET



Data for 1994 represents JEC estimate of actual gains plus estimated gains using S&P 500
Source: Standard and Poor's; Department of the Treasury; JEC

Entrepreneurial talent requires resources, and today's opportunities are better than they have been in decades. New technology is opening the door to productivity gains and new products at a rate not seen since the Industrial Revolution. By reducing the capital gains tax rate and indexing it for inflation, the $1.5 trillion in locked-up gains can be released to fund investment opportunities which create jobs and growth as new investors, both overseas and at home, are enticed into investing in America.

New companies are attracting capital in spite of the current tax system. Nonetheless, given all the new market potential and the tremendous rise in the stock market during recent years, total venture capital investment remains below 1986 levels. Such investment in 1994 was $2.7 billion, only $60 million higher than in 1985 and $501 million below 1986.[36] And, while initial public offerings (IPOs) have increase as the stock market has reached new highs, the 1994 IPO total of 646 is still below 1986's 728.[37]

The benefits to Americans from cutting the capital gains tax rate are many. Increased investment in new technologies will boost productivity, jobs and living standards. At a time when Congress is getting serious about balancing the budget, cutting the capital gains tax rate has the potential to boost federal revenues by more than $225 billion ($1.5 trillion multiplied by a 20% tax rate, adjusted for offsetting losses) above current estimates (which amounts to seven years of capital gains tax revenue at the current pace). These revenue estimates reflect only actual capital gains and do not attempt to measure any boost to economic growth that would ensue.

High capital gains tax rates have led to a dramatic decline in realizations and new investment despite gains in the stock market and the potential of new technologies. These locked-up capital

gains point to higher revenues and more investment in new technology if only the capital gains tax rates are cut.

TAX REFORM IS ESSENTIAL FOR ECONOMIC GROWTH

There is a large and growing consensus among economists, lawmakers, and taxpayers that our current income tax system has become a tremendous obstacle to economic growth and Americans' standard of living. After eight decades of misuse by lawmakers, lobbyists, and special interests, the tax system is unfair, complex, costly, and punishes work, saving and investing. Simply stated, today's onerous tax system is unfit to carry the nation into the 21st century, and threatens the promise of a better future for all Americans.

Since being enacted in 1913, the income tax has fallen prey to a multitude of unintended purposes, including income redistribution, social engineering, and government micro-management of saving, investing, and spending decisions. As a result, it treats individuals unfairly, extracts tremendous administrative and compliance costs, and hinders the economy from realizing its full productive potential. In fact, the current system hinders Americans' potential for a higher standard of living.

The only legitimate purpose of any tax is to provide revenue to cover the cost of government. Taxes should allow taxpayers to clearly see the price of government spending, and thereby determine how much government they are willing to pay for. In order to make the tax system more equitable, efficient, and pro-growth, the following principles must be followed:

All taxpayers must be fully informed on exactly what is being taxed, how they are being taxed, and what their true tax liability is.

Taxes should be as visible to the taxpayer as possible. "Hidden" taxes mask the true cost of government.

The tax system should explicitly treat all individuals equally under the law. Deliberate differentiations in tax liabilities based on the sources or uses of income should be avoided.

The tax system should provide the same tax treatment for similar economic actions and transactions rather than taxation based on the attributes of the taxpayer.

Multiple layers of taxation should be avoided. Income should be taxed once and only once.

The tax system should be simple. Complexity makes the system expensive, punitive, and results in an efficiency loss to the economy.

The tax system should aim for neutrality in economic decision making. The tax system should not interfere with the free-will economic choices and decisions of individuals, households, or businesses.

A low tax rate across a broad tax base creates the least distortions in the economy. High marginal tax rates damage economic growth by reducing the incentives to work, save and invest.

Changes in the tax law intended to raise revenues should not be retroactive. All taxpayers must have confidence in the code as it exists when planning and entering transactions.

The tax code must be competitive with other industrialized nations. It should in now way impede the free flow of goods, services and capital across borders.

Unfortunately, our current tax code violates these basic principles. The complexity and unfairness of federal taxes has led to proposals for simplification. Along with lower rates, simpler filing and ease of compliance are desired. Businesses, concerned about the financial burden on their companies and employees, similarly resent high taxes. Families and businesses are still taxed on inflation, because assets, like many homes and family farms, are usually held for long periods, often through generations. Much inflation, as well as real capital appreciation, is captured because current nominal sales prices are used as the basis of taxation when long-held assets are sold. Personal exemptions for family members have not kept up with inflation, compared with their value in 1950. The purchasing power of the exemption, in constant dollars, should be restored by increasing the exemption amount.

To protect families and businesses from tax increases caused by future inflation, exemptions and asset purchase prices must be fully indexed. To offset present inflation, cost recovery should be enhanced by allowing expensing or accelerated depreciation. Simple low rates provide long-term, stable incentives for businesses and households to increase their future activity, their future income and, if successful, their future tax burdens.

Tax burdens and the cost of regulation often force families to send both parents into the workforce. On average, taxes of all kinds claim almost 40 percent of Americans' incomes. Thus today's parents often work nearly as much to support the government as to support their families, unlike previous generations who paid relatively low federal taxes. Paying these higher taxes has become much more complicated for many taxpayers, and indirect taxes push effective rate even higher. Moreover, government increasingly imposes taxes that citizens can not explicitly see and are not itemized on any tax bill, such as the federal gasoline tax.

Economists broadly agree that increasing savings and investment is essential to capital accumulation. This, in turn, allows new machinery and technology to increase workers' productivity. Ready sources of capital are needed to allow businesses to invest in such equipment. Low savings rates make capital more expensive for private enterprise, and yet the interest from savings is taxed punitively as well. Thus, low savings undermines capital investment.

The manner in which income is taxed must be re-thought, therefore, in order to be equitable, efficient, and pro-growth. Tax tinkering, or simply reshuffling the existing tax burden is not genuine tax reform. A new tax structure must be created that allows everyone to benefit from economic growth while preventing today's anti-growth tax system from ever re-emerging.

Today's major tax reform proposals, a flat rate income tax, a national sales tax and other consumption-based taxes, encompass this new thinking and fundamental change needed to create a fair, simple, and progrowth tax system.

While many of these proposals would help correct the inequities and complexity in our current tax system, the most important reason to undertake fundamental tax reform is to improve the stand-

ard of living. If tax reform fosters just a 0.5 percent increase in GDP growth, the typical American family after five years would have incomes more than $3,000 higher then they would be under current tax law.

Current tax reform proposals are such a fundamental change from the way government does business today that there are no economic models which can fully calculate their impact on economic growth. Nobody, not the Congressional Budget Office, not the Administration's Office of Management and Budget, not the Treasury Department, not the Joint Committee on Taxation, has predicted the dynamic potential of full-fledged tax reform.

No doubt, typical static income distribution and revenue models used to trumpet so-called tax "winners" and "losers" will be used in an attempt to scare us into preserving the status quo. However, these models cannot encompass the real essence of fundamental tax reform: the potential to make everyone better off through economic growth and increase incomes across all classes. Any static comparison of what one pays in taxes today to what they will pay under a reformed tax system simply fails to capture many important aspects of meaningful tax reform. For example:

Would families be better off under a tax reform that lowers interest rates on mortgages, credit cards, and auto loans?

Would consumers be better off with a tax reform that reduces inflation?

Would families be better off under a tax system that would now allow a spouse to enter the work force or get a raise without pushing the family into a higher tax bracket?

Would families be better off under a tax system that would let them save and invest for their future without punishing these decisions with high tax rates and double taxation?

Static analysis has been proven wrong time and time again. Eliminating destructively high marginal tax rates would boost investment, productivity, wage growth, and the standard of living, and, in turn, the Treasury would see an increase in revenues. This is not ideal speculation. When Presidents Kennedy and Reagan lowered marginal tax rates, the economy boomed and tax revenues increased.

Today, the graduated income tax system grabs an increasing share of the fruits of people's hard work and success. it's no wonder Americans feel they are working longer and harder with nothing to show for it. They are.

For too long, the tax code and fiscal policy have grown to accommodate the demands of special interests. Fiscal policy that addresses the economic concerns of typical taxpayers should be instituted by reversing government's tax and spend habits and by promoting economic growth.

POLICY RECOMMENDATIONS OF THE CHAIRMAN OF THE JOINT ECONOMIC COMMITTEE

November 8, 1994 marked a new beginning for America. Voters rejected politics as usual and demanded real change. They said they want a smaller federal government that will leave them alone to make the best lives they can for themselves and their families.

Congress must justify the faith the American people have placed in us to create a smaller, simpler and smarter government. To reach that goal, I propose three common-sense changes to the way government now does business: a Spending Reduction Commission to make government smaller, a Flat Tax to make government simpler, and Humphrey-Hawkins reform to make government smarter.

SPENDING REDUCTION COMMISSION

Even if Congress can agree that 25 years of deficit spending has smothered our economy, and we decide to honor the wishes and demands of the American people by passing the Balanced Budget Amendment, we are still left with the daunting task of actually balancing the budget.

In 1992, my dealings with the Defense Base Closure and Realignment Commission led me to conceive a Spending Reduction Commission to perform the same hard analysis on overall government spending, and force Congress to make the choices that it has fought so long and hard to avoid. It would act as a fail-safe mechanism to ensure American taxpayers that the budget will be balanced through reductions in the growth of spending, not tax increases.

The Congressional Budget Office says that if we cumulatively reduce the growth in spending by less than $50 billion in each of the next six years, the budget will be balanced by the year 2002. Under my plan, if Congress is unable or unwilling to restrain the growth of spending enough through its normal budget process in a given year, the Commission would create a package of additional restraints to meet the target. That package, without any amendments, would receive a straight up or down vote, so individual members would be effectively prohibited from protecting their prized political pork without publicly attacking the entire package.

An old saying goes: the reason the men at the Alamo fought so bravely is that there was no back door. The Spending Reduction Commission would nail the back door shut, and force Congress to cut the growth of spending one way or another. It would provide an ironclad guarantee that the budget gets balanced through spending restraints, not tax increases.

THE FLAT TAX

When the 16th Amendment, which established the federal income tax, was ratified in 1913, the maximum legal tax rate was 7 percent, and less than one of half of one percent of the population even had to file a tax return. By the 1960s, the United States had a top marginal tax rate over 90 percent. Thanks to John Kennedy and Ronald Reagan, that rate was eventually cut by more than half. But in 1993 President Clinton and his allies in Congress began pushing the top rate up once again.

Not only is the tax burden on American families now at a record high, but taxpayers spend $190 billion and 6 billion man-hours just to comply with our burdensome tax code. To put that last figure in perspective, producing all the cars, trucks and airplanes made in America each year also takes 6 billion man-hours.

But even if we somehow choose to ignore this incredible waste, we can't ignore the way high tax rates combined with double, or

even triple taxation of income punishes success, stifle work, discourage saving, and push investment into unproductive tax shelters. In short, the tax system we have today dangerously erodes the productive potential of our economy, and reduces every American's standard of living.

Under a flat tax, everybody who pays income tax faces the same rate. Today's high tax rates would be drastically reduced, and Americans would realize major tax savings up front. The system would be both simpler and fairer. Appropriate individual allowances and dependent deductions would ensure that the flat tax is not regressive. In fact, low-income families would be removed from the tax rolls altogether.

As the new rate is implemented, the tax loopholes and giveaways that now go to special interests would be eliminated. There will surely be howls from those who want to preserve their own favorite deductions and tax benefits. However, as things now stand, the governmental takes a huge chunk of peoples' incomes, and then tries to bribe them with their own money through government-approved deductions and allowances. A low-rate flat tax would allow everyone to keep more of what they earn from the start, so individuals could decide for themselves how to use their own money.

HUMPHREY-HAWKINS REFORM

In 1978, Congress passed and President Carter signed into law the Humphrey-Hawkins Act. Humphrey-Hawkins is every big-government, tax-and-spend liberal's dream. It gives the federal government responsibility for simultaneously promoting full employment and reasonable price stability. Of course, it had little support from anyone who had ever actually created a job in a real business.

By forcing the Fed to focus on employment and growth, Humphrey-Hawkins set up the age-old conundrum of serving two masters. In trying to satisfy both, neither is pleased. As a result, the Fed often must make decisions in the short-run that are not good for the economy in the long-run. The Fed may boost employment in the short run, but always at the expense of inflation. History shows that stable prices provide the best environment for long-term economic growth and increases in standards of living.

The Fed should have only one focus: controlling inflation. By following sound money policy, it can create the stable environment that businesses need to make sound decisions. Protecting the value of Americans' income, savings, and investments from the ravages of runaway inflation will bring dramatically lower interest rates, stronger economic growth and permanent increases in employment.

Humphrey-Hawkins is a classic piece of Washington arrogance. It ignores the fundamental economic realities that government cannot legislate prosperity, that businesses create jobs, and that free markets lead to economic growth. Government should help foster an economic environment of low taxes, free markets, stable prices, and a respect for private property in which individuals can prosper. Congress and the President should work to keep taxes low and markets free, while the Federal Reserve should maintain a stable value for our money.

All three of these proposals, the Spending Reduction Commission, the Flat Tax, and Humphrey-Hawkins reform, would change

government for the better. But even so, they only fix mistakes of the past. Turning to the needs and opportunities of the future, I look forward to a much smaller government, a dynamic and growing economy, and the ascendancy of the individual.

THE FUTURE

Americans own their government. That means government works for us, and as employers, we have to ask if our employee is doing the job. If any other employee did such shoddy work for exorbitant wages, insisted on spending his time doing what he though was important rather than what he promised he would do, showed disrespect, and even contempt, for both his customers and employers, and spent more time worrying about feathering his own nest than increasing the bottom line, he would be fired. Rightly so.

The time has come to confine the government to those duties specified in the Constitution. For too many Americans, the government acts not as a helpful servant, but as an insensitive master. Shrinking the government would put responsibility and opportunity back where it belongs, in the hands of the people. Freed from the oppressive weight of taxes and regulation, our economy will grow and all Americans will benefit. Individuals must be allowed to realize their dreams.

America is entering a new age. Futurist author Alvin Toffler calls it the Third Wave. With tremendously expanded access to information—educational, vocational, and even entertainment—the technology revolution is changing how we work, how we play, how we team, and even how we think. This revolution will give individuals the ability to control their lives and provide for their families in ways they could not have dreamed of until now. the future holds promises only our children will be able to imagine.

America is the beacon of freedom and opportunity for all the world. But unless we dedicate ourselves to keeping the beacon shining brightly, it will surely dim and die. Only government can stop us from realizing our dreams by stifling our creativity, taxing away our incentive, pitting us against one another, and simply making life harder than it has to be.

The battle to make government smaller, simpler and smarter is one we can not afford to lose. Our success will usher in an age of unparalleled prosperity and unprecedented expansion of freedom. This is the real promise of the 1994 elections. Working together, we can offer our children a future with less taxes, less spending, less government, and more freedom.

GETTING BACK TO PROSPERITY: THE VIEWS OF VICE-CHAIRMAN SAXTON

INTRODUCTION

Our Nation stands at a rare historical crossroad. For the first time in forty years, American citizens are being presented with a real alternative to big-government taxing, spending, and regulating. The Republican majority in Congress is offering a strategy to expand the economy and let taxpayers keep more of their income.

In the Republican Views section of last year's "Joint Economic Report," it was shown that the Clinton administration's policies of

high taxation, regulation, and spending would be deleterious to the economy. The predictions of "robust economic growth to come" made by supporters of the administration's policies (many of whom have since been voted out of office) have not come to pass. In fact, just the opposite has occurred, and the question foremost in people's minds today is, "how soon before today's economic slowdown turns into a recession?"

Last year, the JEC Republicans predicted that the combination of high taxes and monetary contraction would imperil the economy. The administration ignored the advice and continued its misguided policies. The situation is even more precarious for long-term economic growth.

Investment is crucial to raise the wages of workers and to provide the foundation of economic growth. Due to the unfortunate policies of the Clinton administration, Americans are not investing enough to provide for future prosperity. In the "Economic Report of the President" 1995, the administration admits that its policies cannot raise real economic growth above 2.5 percent per year. Though the administration's economists are unable to offer a solution, they correctly, if unwittingly, identify the problem—higher taxes. Because the President's tax increase burdened successful entrepreneurs, the administration's economists say that these income earners "are presumably more likely to make the [tax] payments out of savings."[38] Reducing savings to pay taxes destroys investment. Tax relief on investment is important for robust economic growth.

Economic expansions do not die of old age. Rather, they are killed off by misguided government policies. The combination of Clinton's tax increase and tight monetary policy in the aftermath of loose monetary policy, in 1991, 92, and 93, is slowing the economy. Congress thus must respond to limit the economic damage. The Contract With America and the House Republican budget are just the first steps to restore sanity to public policy.

LESSONS FROM THE REAGAN EXPANSION

The 1980s taught a very valuable lesson. The experience of the Reagan revolution demonstrated that the economy performs admirably when government reduces its size and scope.[39] The evidence from domestic affairs is bolstered by the experience of other countries that have reduced the size of government, such as Chile, New Zealand, and Great Britain.

On the other hand, the failures of the economies of Central and Eastern Europe demonstrate the perils of excessive government intervention. The current economic discord in Japan, Germany, Sweden, and other countries with large government bureaucracies also shows the need to drastically downsize the government in mixed capitalist economies. International evidence further substantiates the argument that large government harms the economy and that the economy benefits from reducing government's size.

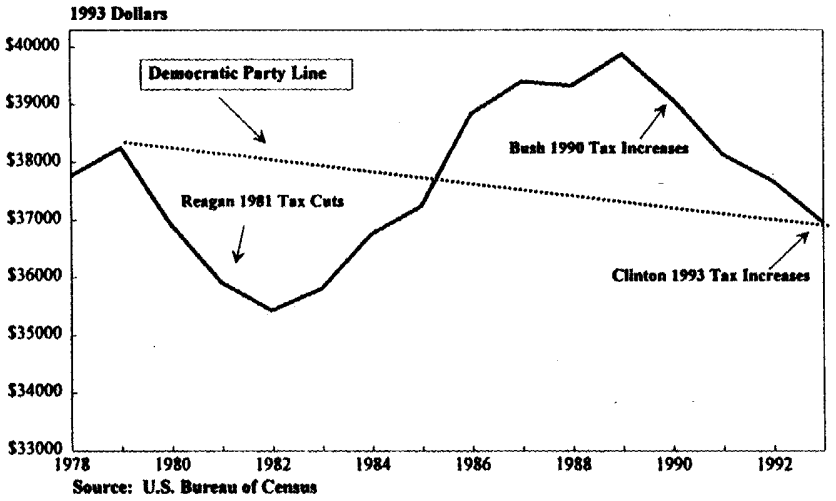
When President Reagan reduced taxes and began to chip away at the layers of federal bureaucracy, the economy responded with the longest peacetime expansion in U.S. history. Unfortunately, those lessons were ignored by the Bush administration. Although President Bush started well by promising no new taxes, his ulti-

mate capitulation to congressional Democrats on higher taxes, more federal spending, and increased regulation created significant economic difficulties which in conjunction with destructively tight Fed policy, culminated in the recession of 1991.[40]

President Clinton benefited politically from the failed economic policies of President Bush and the Fed. The recession was an important factor aiding his election. However, Clinton chose to ignore the lessons of the Bush and Reagan administrations. The Clinton and Bush administrations were too narrowly focused on the deficit. They both succumbed to the temptation to solve the problem of the deficit on the backs of American taxpayers rather than by reducing government spending. The economic performance of both administrations has failed to match the standards of earlier periods of U.S. economic history.

Incomes rose for all income classes while Reagan was President, contrary to the rhetoric of the Clinton administration (Chart 1). In 1993 and the first three quarters of 1994, the economy grew but the median family income fell. The last time the economy grew and median incomes fell was when Jimmy Carter was President. The November elections that swept Republicans into control of the Congress were largely a response to the failure of the administration to improve the lives of American families. Yet, the Clinton policies have not changed during the first two-and-one-half years of the administration.

Chart 1
MEDIAN FAMILY INCOME

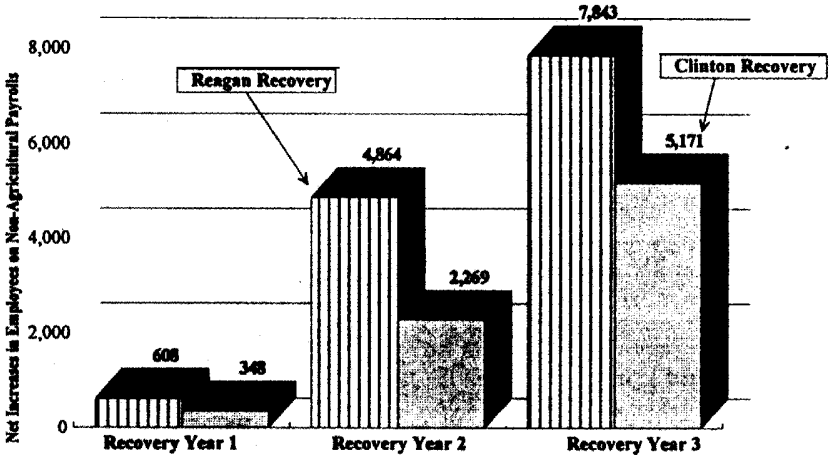


THE BURDENS OF ERRONEOUS POLICIES

The administration still argues that its tax increases have not hurt the economy. Two points need to be stressed when talking about Clinton's tax increases. First, when taxes are raised in the midst of an economic recovery, the result may be to retard growth,

not necessarily produce an immediate recession. Second, the way the Clinton tax increases were implemented, the depressing economic effect was delayed. The current expansion has been fairly poor compared to earlier expansions. Chart 2 demonstrates the poor job performance compared to earlier periods.

Chart 2
A COMPARISON OF RECOVERIES



Source: Economic Report of the President, 1995

The expansion has been wounded by the 1993 Clinton tax increase. The effects of the tax increase can be seen in income statistics. While nominal incomes rose in April 1995, real disposable incomes (income left after taxes) fell 1.1 percent. Real disposable income fell for two reasons.

First, payment on the 1993 tax increase came due for many Americans on April 15, 1995. Second, the Clinton economic plan failed to lower interest rates as forecast by administration supporters. Too many Americans are seeing their incomes consumed by taxes and higher interest rates due to Clinton's economic policies.

Fiscal policy is only one area where the government can affect economic growth. Monetary policy has an important impact on short-term growth, and no recounting of Clintonomics would be complete without a full description of the Fed's role.

The Federal Reserve expanded the money supply dramatically in 1991, 1992 and 1993. Total bank reserves grew by as much as 20 percent annually in 1992 and continued to grow by 10.6 percent throughout 1993. The result of this monetary expansion was to create an artificially strong economy in 1994—a false prosperity.

The Fed has created a dilemma. Excessive monetary expansion in 1991, 1992, and 1993 masked the impact of the 1993 tax increase. Now the Fed is reacting to its own past policies with excessive restraint. If the Fed governors continue unwarranted monetary restraint now by artificially propping up interest rates in com-

bination with Clinton's tax increase and regulatory excesses, it will surely deliver a recession.

Sound fiscal policy can, in part at least, overcome inconsistent, stop-and-go monetary policy. The Republicans have made the "Contract With America" an important part of the solution to the economic woes of the country. The economic policies of the "Contract" recognize that short-term economic difficulties require the same policies as those that maximize long-term economic growth. Government spending needs to be reduced. Taxes need to be decreased. And regulation needs to be limited.

THE GROWTH DEFICIT

The current difficulty in the U.S. economy reinforces a larger and more disturbing long-run trend. There is a gap between potential economic growth and the economic growth actually realized in the 1970s and 1990s which has been labeled the "growth deficit." The evidence demonstrates that the growth deficit is caused by large, invasive government.

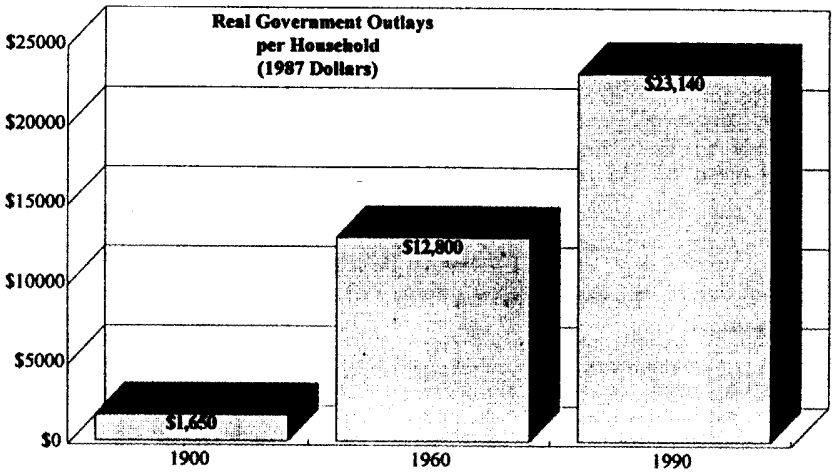
The "Contract" begins to address the need for increased economic growth. The most important measures in the "Contract" dealing explicitly with economic growth are the tax cuts. Contrary to Laura Tyson's assertion that there is no relationship between tax burdens and economic growth,[41] reducing the tax strain on private citizens is vital to future prosperity. The "Contract" includes tax breaks for families with the $500-per-child tax credit, capital gains tax reduction and neutral cost recovery to spur investment, and elimination of Clinton's tax of Social Security benefits. Reducing the tax burden is always the first step for revived economic growth.

Many critics of tax cuts have argued that deficit reduction takes priority over tax breaks. In fact, deficit reduction, when placed in its proper perspective, is viewed as a desirable artifact—a good byproduct of more fundamental changes, smaller government, lighter and less-intrusive taxes. Most Americans recognize that government is too large and invasive. Chart 3 demonstrates the extraordinary burden government has become. Reduction of taxes is vital to restore the proper role of government—to serve its citizens.

The "Contract" is the first attempt since the aborted Reagan revolution to restore the proper relationship between the government and the governed. Republicans recognize that they are the servants of the people and need to respond to the needs of citizens. However, the "Contract" is simply a first step in the process to restore American prosperity. The future requires a government that is much smaller and less intrusive.

Chart 3

THE EXPANSION OF GOVERNMENT



Source: Stephen Moore, Government: America's #1 Growth Industry, 1995.

REDUCE SPENDING

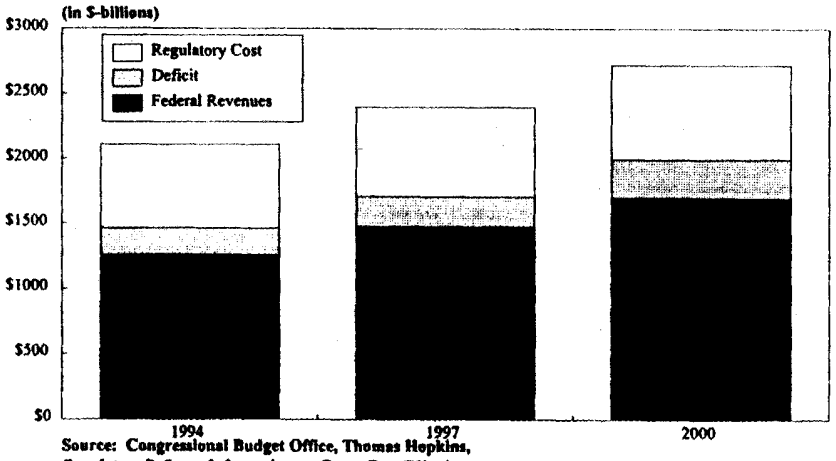
The next step taken by the Republican majority was to propose sufficient spending restraint to balance the budget. Spending has jumped from $210 billion to $1.6 trillion in 25 years. Congress's budget recognizes the problem of this excessive spending. The projected Republican budget would reduce the share of GDP spent by the federal government to 18 percent, still too large, but it is the first Congressional attempt in forty plus years to balance the budget by limiting the size of government, not by raising taxes. The President's proposal to balance the budget is deficient on each of its critical dimensions: it increases spending, it raises taxes, and it fails to balance the budget.

Federal government spending has risen too rapidly to maximize economic growth. It is instructive to compare the growth of federal spending to private spending on items of importance. Since 1970, federal spending as a percent of GDP has risen from 19 percent to 22 percent. During the same period spending in vital areas of food, automobiles, and clothing has fallen; for food, from 13 percent to 10 percent; for automobiles, from 4.2 percent to 3.7 percent; for clothing, from 4.7 percent to 3.7 percent. Private spending on housing rose from 9.3 percent of GDP in 1972 to 9.8 percent in 1994 primarily due to the explosion in the number of families in recent years. Moreover, in the one area of the private economy that has experienced the greatest amount of federal intervention over the years, medicine and health care, private spending is increasing as a share of GDP and, under current administration policies, is expected to rise even further.

REGULATORY COSTS

Regulations and mandates on the private economy have increased as well. The impact of regulations is very hard to quantify. Thomas Hopkins has attempted to quantify their costs (Chart 4). The cost of regulations is triple the deficit and half the cost of taxation. Thus, the total burden of the federal government is $2.1 trillion. The federal government's burden is one-third of the U.S. GDP. 130,000 bureaucrats work to devise and enforce these regulations. The Federal Register, the list of federal regulations, has mushroomed from 44,812 pages in 1986 to 64,914 last year.[42]

Chart 4
THE FEDERAL BURDEN:
TAXES, REGULATION AND DEFICITS



Source: Congressional Budget Office, Thomas Hopkins, *Regulatory Reform: Information on Costs, Cost-Effectiveness and Mandated Deadlines for Regulations*

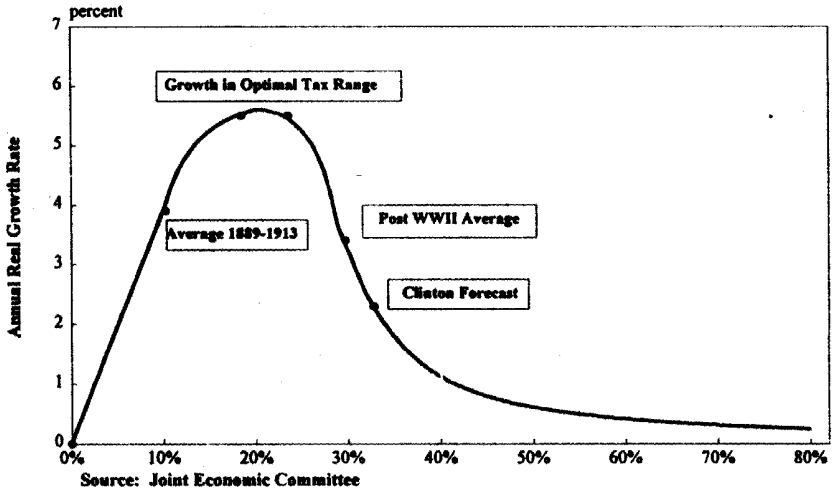
Regulatory costs are not spread evenly throughout the economy. Regulations force higher costs on industries like timber, pharmaceuticals, and automobiles. At its current rate, the federal government will be testing pesticides until the year 15000 A.D. just to comply with current regulations. The federal government for too long has adopted these regulations without any consideration of the costs and benefits.

THE OPTIMAL SIZE OF GOVERNMENT

The increase in federal spending, absolutely and relatively, would not be so alarming if increased government spending added to the general welfare; if the benefits of increased spending outweighed the costs of extracting funds from the private sector. However, careful research by distinguished economist Gerald Scully points out that government is too big in the U.S. to obtain full growth potential. Scully suggests that reducing spending of all levels of government in the economy by a third (from its current level of about 33 to 22 percent or less) would unleash economic growth.

Chart 5 illustrates the research findings of Dr. Scully. The federal government would have to fall to a maximum of about 15 percent of GDP to be able to reap the greatest rewards from spending policy changes or fall even further if states and localities shoulder more of the burden of government. The size of government must fall further than Scully suggests if regulation grows.

Chart 5
BIG GOVERNMENT HURTS ECONOMIC GROWTH



Source: Joint Economic Committee

But it isn't just economic science or meaningless manipulation of numbers, it is common sense. Curtailing federal spending confers benefits now to taxpayers and brings dividends of faster economic growth later. Since federal spending entails some combination of federal taxing, borrowing, and money creation, curtailing spending will lead to a lessening of burdens on taxpayers, or on credit markets, or a reduction in inflation, or some combination of all three.

As the relative share of government declines, private citizens will put a smaller portion of the income they earn to taxes, less of their savings will go to government borrowing, and wealth accumulated in the form of money will not be eroded as quickly because inflation will be lower. In short, slowing the growth in federal spending sufficiently will leave more funds in the private sector to allow the economy to grow more rapidly over time. As private citizens retain more income and economic growth accelerates, the federal government will, in the long run, mazimize revenues.

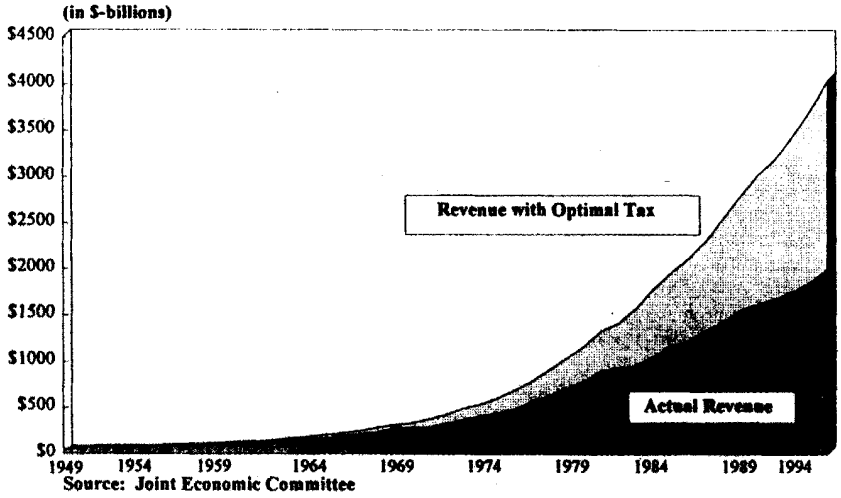
If there is one thing most Americans are now aware of, it is that the federal government has grown so large and its powers appear so great that ordinary citizens have no say in setting policies. This must change. The goal should be to catch up to our growth potential by freeing the economy to function to its fullest.

The solution to the years of federal mismanagement is to build an economy capable of rapidly expansive growth. Chart 6 demonstrates how the government would receive much larger revenues

by enacting pro-growth policies. The deficit is much easier to solve if economic growth is maximized.

Chart 6

GOVERNMENT REVENUE: ACTUAL VS. POTENTIAL



THE BUDGET

Present budgetary reforms are aimed at holding the line on the relative amount that government spending takes from the economy by curtailing the growth in the absolute amount of spending. Taking this one step further toward meeting longer-term goals, the Congressional budget, projected to be balanced in 2002, keeps spending increases to a minimum across-the-board. Also, it proposes ways to slow the rate of increase in rapidly expanding programs, such as Medicare and Medicaid, by enacting market-based reforms. However, to unleash the full potential of private markets and to make up for lost economic ground, it is necessary to eliminate burdensome regulations and mandates on the economy the costs of which may swamp many of the possible benefits from reduced spending. Unleashing private markets is vital so that the economy can grow closer to its full potential.

It is now possible to build coalitions to pursue the goals of higher economic growth and a lower relative share of federal spending. Tax cuts to spur investment will go to entrepreneurs. At the same time, it may be possible to reduce federal spending on the more than 125 programs that subsidize corporations. In fiscal year 1995, more than $85 billion will be spent on these programs. Business interests will support removing their own subsidies if they recognize the benefits of economic growth with a small government and less burdens from taxation and regulation. If welfare reform is designed to limit how long recipients can be eligible for federal funds, it makes common sense to limit the duration of all subsidies to private business or to put an end to corporate welfare as we know it.

REFORM THE TAX SYSTEM

Many areas require a reevaluation of the role of government but nowhere is this more needed than in the area of taxation. The current tax system is incredibly burdensome and costly. The government's attempt to collect the income tax is too intrusive into the lives of American citizens. The complexity of the income tax makes it almost certain that most Americans are making significant errors in their tax preparation. The income tax allows too many people to evade their fair share of the burden.

Ten million people are delinquent "non-filers." It takes 5 billion man-hours to administer and comply with the income tax. That is more man-hours than it takes to produce all the cars, trucks, and vans in America. The Internal Revenue Code is thousands of pages and the regulations and court decisions interpreting the law are hundreds of thousands more. In 1992, Money magazine had 48 professional tax preparers figure out the taxes owed by a hypothetical family and received 48 different answers ranging from $16,219 to $48,564. Only a few were close to the right answer of $26,619. Recently, the chief tax accountant of Mobil Corporation testified before the House Ways and Means Committee. He said the company spends 57 man-years and $10 million dollars just to prepare one year's tax return.[43]

A recent GAO study found that more than forty percent of returns that claim an earned income tax credit (EITC) are incorrect or fraudulent. It is estimated that corporations spend $300 billion per year just to comply with tax laws. All of the time, cost, and effort individuals spend preparing their tax returns is a loss to the economy. In order to release the full potential of the economy, Congress and the President must consider changing the tax system to a flat rate consumption or sales tax that removes the problems of the current system. If government reform seeks to take the country to a more rapidly growing economy with a lesser relative role played by the federal government, the tax system must be changed to facilitate this growth and to reduce the tax burden on all Americans.

Moreover, recent developments in smart-card technologies and electronic money show the handwriting on the wall of the IRS. Either the income tax as it currently exists will self destruct as anyone who chooses to do so will be able to escape taxes on interest, dividends, and capital gains with virtually no danger of being caught; or the tax-collecting bureaucracy will become increasingly oppressive in a futile attempt to collect the income tax in a manner totally incompatible with a free society.

Currently, taxes on capital inhibit economic performance. To get higher economic growth in the future, taxes on capital must be cut dramatically as soon as possible. The House has provided for four provisions of the "Contract" that will cut taxes on capital and boost investment: capital gains tax reduction, neutral cost recovery, estate and gift tax reform, and increased expensing for small businesses. All of these measures serve to remove the onerous tax burden on investment which is limiting the growth of the economy.

In rethinking tax policy, it is important to understand the analytical context for change. Cutting the tax on capital serves to en-

courage its use. More capital will lead to higher wages, higher real incomes, and greater real tax receipts over time. Unintentionally, "soak the rich" taxes and higher taxes on capital income have hurt lower income and less skilled workers the most. Rather than "punishing" higher income people, taxes on the rich have served to discourage further investment thus retarding productivity and real wage growth. Continuing down this path—to tax the "rich" even to "compensate" for tax cuts for others—is unacceptable. It is no wonder that many economic forecasts are so pessimistic. Current tax policy lacks the right stuff to raise real hope.

One overlooked benefit to cutting taxes on capital is its potential to reduce income inequality over time. By raising real wages, reducing taxes on capital encourages greater workforce participation and spurs investments in human capital, education, and training. Typically, prolonged periods of economic growth result not only in higher real wages, but also in less unequal income distributions. Whenever we enlarge the economy's stock of physical and human capital, the relative income shares of those already wealthy decline. As a result, the gains from economic growth are spread more evenly across the population.

THE PROBLEM OF POLITICAL WILL

It should be the case that common sense and good economic sense will make for good political sense. But it is politically difficult to legislate actual spending cuts in almost all federal spending programs. The reason is that regardless of the benefits to society, there are well-organized constituencies working for every federal dollar spent. These special interests are trying to augment, or at least maintain, their current levels of funding.

Every legislator who wants to be re-elected must defend certain spending programs that benefit a particular constituency's affairs. However, legislators' attempts to benefit their political constituencies are often to the detriment of the broader economy. The greatest success of this Congress, with its Republican majority, is that legislators are putting aside narrow interest to benefit the whole national economy to a greater degree than before. But the reform process must continue. Too many programs have excessive funding levels or have outlived their usefulness.

The Clinton administration is doing its best to thwart the reform efforts. Administration officials do not seem to recognize that many programs are economically harmful. Currently, for example, the Department of Labor is attempting to direct pension managers to invest in areas politicians and bureaucrats deem "socially beneficial." The administration has inappropriately deemed these investments "economically targeted investments." The administration is really attempting to force pension managers to invest in a politically correct manner to the detriment of pensioners. Saving and investment is already depressed artificially by perverse government incentives, and the administration's attempt to undermine pensions would only further exacerbate the low level of savings. The Republican majority in Congress recognizes the perils of the Clinton administration's pension policy and will prevent pension funds from being diverted into politically misguided investments.[44]

There are voices from several places that claim that the economy cannot grow too fast without igniting inflation. There is no economic rationale why economic growth cannot exceed the pessimistic view found in the 1995 "Economic Report of the President." Economic growth does not cause inflation. Rather, inflation comes from too much money chasing too few goods and services. If the nation embarks on a course that raises the amount of goods and services, this serves to retard inflation. A given amount of money will be chasing more goods and services, and inflation will subside. If Congress commits itself to reducing the costs of producing goods and services by removing economically harmful regulations, this too will cut back on inflationary pressures since the costs of regulation are embedded in the price of every good and service sold.

In the notion that the economy isn't what it used to be is accepted and if it becomes conventional wisdom that nothing can be done to revitalize it, no progress will be possible. America has fallen too far behind its potential and economic policy must change course quickly to provide future Americans their chance at the American dream.

CONCLUSION

The U.S. economy has largely been spared the ravages of statism that have plagued other industrialized countries. The result is the largest, most productive economy in the world. However, if Americans follow the lead of the President and become resigned to "two-something" growth as the best that can be hoped for, the nation's wealth will continue to erode.[45] For too long now, government has squandered the hard-earned fruits of workers' labor and stifled the spirit of entrepreneurs. The Republican majority seeks to redirect government policy so that government can provide an environment for economic growth. The guiding principle to achieve this "prosperity-friendly" environment is to make government smaller and less invasive.

The American dream is eluding too many Americans. The combined weight of forty years of government bureaucracy and taxation has shifted dollars from families to policy makers. by restoring the proper role of government, the Republican majority in Congress will start the economy along the path to greater prosperity.

ENDNOTES

[1] DRI/McGraw-Hill, "Growth and Budget Repercussions of the Republican Contract with America," February 1995.

[2] Von Mises, Ludwig, "The Theory of Money and Credit," published by The Foundation for Economic Education, Inc., New York, 1971, page 414.

[3] Wesbury, Brian S., "Freeing the American Economy," Joint Economic Committee, May 1995.

[4] London Financial Times, August 4, 1995, "Growth in Trade Will Lift World Economy, Say Forecasters."

[5] International Finance Corporation, "Emerging Stock Markets Factbook 1995," June 1995.

[6] U.S. Department of the Treasury.

[7] Ibid.

[8] Angell, Wayne, "Flights of Fancy," The Global Spectator, Bear Stearns, August 1, 1995.

[9] Department of Commerce, Bureau of Economic Analysis, annual averages.

[10] Milton C. Cummings and David Wise, "Democracy Under Pressure," Harcourt Brace Javanovich Publishers, 1985, pp. 349–350.

[11] Department of Commerce, Bureau of Economic Analysis; also Bureau of the Census.

[12] Ibid.

[13] Department of Commerce, Bureau of Economic Analysis.

[14] Ibid.

[15] Ibid.

[16] Ibid.
[17] U.S. Department of Commerce, Bureau of Economic Analysis.
[18] Milton Friedman, Ph.D., "Statement before the U.S. Congress Joint Economic Committee," January 20, 1995.
[19] Thomas D. Hopkins, Ph.D., "Statement before the U.S. Senate Committee on Governmental Affairs," February 8, 1995, based upon and updating Hopkins' "Federal Regulatory Burdens: An Overview," RIT Public Policy Working Paper, Rochester Institute of Technology, 1993.
[20] Victor A. Canto and Arthur B. Laffer, "The Ubiquitous Regulatory Wedge," published by A.B. Laffer, V.A. Canto & Associates, La Jolla, California, March 13, 1992, and updated with data from Marvin Zonis and Associates, Chicago, Illinois.
[21] United States Department of Commerce, Bureau of Economic Analysis, 1947 3Q to 1966 Q1 then Q1 1966 to Q4 1994.
[22] United States Department of Commerce, Bureau of Economic Analysis; Bureau of the Census, "Current Population Reports."
[23] "Economic Report of the President 1962," p. 9.
[24] "Economic Report of the President 1965," p. 4.
[25] U.S. Department of Commerce, Bureau of Economic Analysis, Quarterly Statistics 82:4 to 89:1 = 3.9 percent.
[26] Federal Reserve Chairman Alan Greenspan, "Statement before the U.S. House of Representatives Banking Committee," February 22, 1995.
[27] U.S. Department of Labor, Bureau of Labor Statistics.
[28] Ibid.
[29] Haver Analytics.
[30] Joint Economic Committee Economic Policy Update, "Capital Gains Tax: Fairness?" by Brian Wesbury and Jeffrey Given.
[31] Price Waterhouse, "Individual Taxes, A Worldwide Summary," 1994 edition.
[32] U.S. Department of the Treasury, Office of Tax Analysis.
[33] U.S. Department of the Treasury, Office of Tax Analysis; Joint Economic Committee.
[34] Standard & Poor's.
[35] The $2.7 trillion figure is based on 1985 realizations growing by the same percentage as the S&P 500 on a year-to-year basis. The $1.2 trillion comes from the U.S. Department of the Treasury, Office of Tax Analysis (along with a Joint Economic Committee estimate for 1994).
[36] Securities Data Company.
[37] Ibid.
[38] "Economic Report of the President," 1994, pp. 74–75.
[39] See Barro, Robert J. and Sala-I-Martin, Xavier. 1995. "Economic Growth." p. 7.
[40] Only Ten Republicans voted for OBRA 1991 which enacted the Bush tax increases.
[41] Los Angeles Times, June 6, 1992.
[42] U.S. News and World Report. February 13, 1995. p. 70–72.
[43] Morgan Reynolds, "The Texas Republic," forthcoming.
[44] H.R. 1594, sponsored by Rep. James Saxton with strong leadership support and over 90 cosponsors.
[45] ". . . the consensus view that the sustainable rate of growth is about 2.5 percent per year is slightly more optimistic than a purely mechanical reading of recent experience would warrant." "Economic Report of the President," 1995. p. 96.

MINORITY VIEWS

INTRODUCTION

"There is always an easy solution to every human problem—neat, plausible, and wrong"—H.L. Mencken, 1949.

Many Americans have been justifiably dissatisfied with the performance of the economy over the past twenty years or so. Many workers' wages have not even kept up with the modest inflation we have experienced over the past decade. Families have faced a dilemma. Either they have had to live with a stagnant material standard of living, or they have had to work longer hours or take a second job, sacrificing time at home or in the community in order to shore up their family finances. More children and more full-time workers are living in poverty.

With the elections of 1992, Democrats took control of both the White House and Congress for the first time in twelve years. With no Republican support, Democrats made tough and complex budget decisions that saved half a trillion dollars of red ink over five years. Long term interest rates declined and, after two years of a "jobless recovery" in 1991 and 1992, the economy came to life. Between January 1993 and November 1995, almost 7.7 million new jobs were created. Production of goods and services grew faster in each of the past three years under Clinton than it had during any of the previous four years under Bush.

Reducing the deficit and moving the economy into the expansion phase of the business cycle were two important components of the Democrats' program to reverse the fiscal excesses of the Reagan administration and the economic policy drift of the Bush administration. A third was to reinvent and reinvigorate government to play an appropriate role in fostering strong, sustainable economic growth—growth that would restore the expectation of American families in a steadily rising standard of living.

Democrats have not offered an easy answer or a quick fix to this dilemma. We know that it takes time for deficit reduction and government investment to pay off in better long term economic performance and rising living standards. Still, it is hard to blame the average American family if they have remained concerned about their economic future and impatient with Washington economic policy, even as the economy has shown impressive short term results.

With the elections of 1994, Republicans took control of Congress and offered a very different version of economic policy. Far from a constructive reform of government to preserve and strengthen what is good while winnowing out programs that are low priority, the new Republican majority has adopted a slash and burn approach to many important government programs. Heedless of the lessons of the 1980s, when large tax cuts ushered in an era of $200–300

billion annual budget deficits, they have again proposed large tax cuts, most of whose benefits will go to those who are already very well off.

No Democrat on the Joint Economic Committee believes that government is the answer to all this Nation's economic problems or that every existing government program represents the wisest possible use of our scarce budget resources. But we do believe that in their zeal to slash spending and eliminate agencies, many Republicans have lost sight of the enduring problems that the programs they want to dismantle were created to address.

As recently as the 1989 Joint Economic Committee annual report, Republicans and Democrats struggled to offer a bipartisan analysis of the Nation's economic challenges within a common policy framework. Now, Republican leaders in Congress are proposing changes to fundamental aspects of previously bipartisan national economic policy. Coming under attack are such economic policies as:

Requiring monetary authorities to be concerned about growth as well as inflation,

Designing fiscal policy to stabilize the business cycle and invest for future growth,

Imposing taxes according to ability to pay,

Assisting those less able to help themselves—particularly children and the elderly, and

Assuring that those who work can escape poverty, through a decent minimum wage and earned income tax credit.

In each case, the framework of current policy was forged with strong Republican support for Democratic initiatives. Yet in each case, current Republican leaders have proposed overturning the long-term policy with "neat, plausble, and wrong" solutions.

Many hard-working Americans have come to fear either that our economy is on longer prospering or that they have been left out of whatever prosperity there is to share. The central challenge for national econmic policy today is to restore hope to those people. As we consider the new Republican initiatives to overturn current policies, we should ask this question "Will this proposal permit more Americans to share in economic prosperity or will its benefits accrue to a privileged few?"

DEMOCRATIC POLICIES LAY FOUNDATION FOR THREE YEARS OF STRONG GROWTH

The past three years have registered among the best performances for growth and jobs during the post-war period. The economy has performed better under the policies of the Clinton administration than it did under those of his immediate predecessor, George Bush, as all acknowledge. But the economy has also done better—and this is less well known—than under the Reagan administration, a time that the Republicans consider a "golden age" of economic policy.

One of the underlying themes of the prevailing Republican rhetoric is that the budget and regulatory policies of the Clinton administration have weakened the American economy, resulting in inadequate economic and job growth. They long to take us back to the policies of deregulation and tax cuts for the rich which make the

Reagan era, in their minds, an economic golden age. This Republican story bears no relationship to the facts.

Economic Recovery under Clinton. As Table 1 shows, GDP has grown faster under Clinton than either Bush or Reagan, job growth has been stronger, productivity growth is higher, and inflation is lower. The economy, in fact, has done better by virtually every important economic measure under Clinton than under any post-war Republican administration. Indeed, one has to go back to the Kennedy-Johnson administration to find a better economic performance.

TABLE 1.[1]—ECONOMIC PERFORMANCE UNDER THE CLINTON, BUSH, AND REAGAN ADMINISTRATIONS

[In percent]

	Clinton	Bush	Reagan
Average Annual Growth of Real GDP	3.6	1.3	2.8
Average Annual Growth of Jobs on Nonfarm Payrolls	2.4	0.5	2.1
Average Annual Increase in Output per Worker	2.4	1.3	1.2
Average Annual Inflation Rate	2.7	4.2	4.2

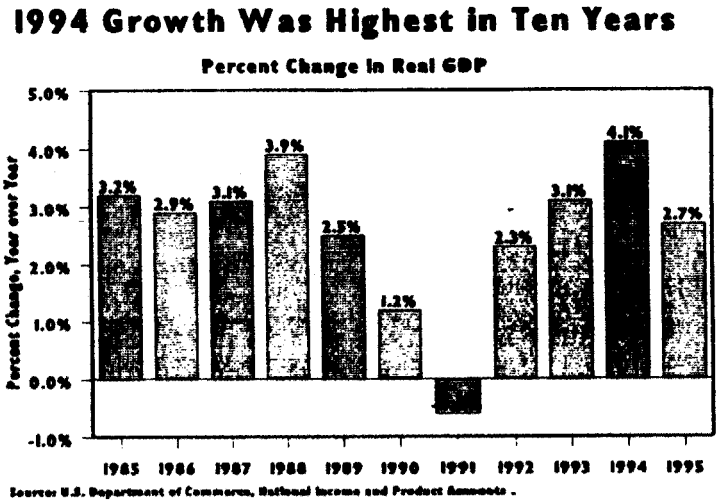
[1] The Reagan administration is measured from the first quarter of 1981 through the first quarter of 1989 or January 1981 through January 1989; Bush from first quarter 1989 through first quarter 1993 or January 1989 through January 1993; Clinton from first quarter 1993 through third quarter 1995 or January 1993 through November 1995.

Most other economic indicators also report "Advantage: Clinton." The Republican contention that the economy has performed poorly under Clinton is simply wrong. Their conclusion—that the economic policies of the Clinton administration have hurt the economy—is also wrong.

A brief overview of economic history under the Clinton administration is in order. During its first two years, the job of the Clinton administration was to restore the economy from the disappointing performance of the Bush administration. It was widely recognized as Clinton took office that a substantial period of strong economic growth and job growth would be required to bring the economy back to its potential and reduce the lingering unemployment.

And this is in fact what happened. Growth was far stronger under Clinton than Bush. From the first quarter of 1993 through the fourth quarter of 1994, real GDP grew at an annual rate of 4.0 percent, or triple the growth rate under Bush and about a third faster than the postwar average. Growth during 1994, in fact, was the strongest in ten years as Figure 1 shows. This strong economic growth closed much of the gap between actual and potential GDP that was inherited from the Bush administration.

Figure 1



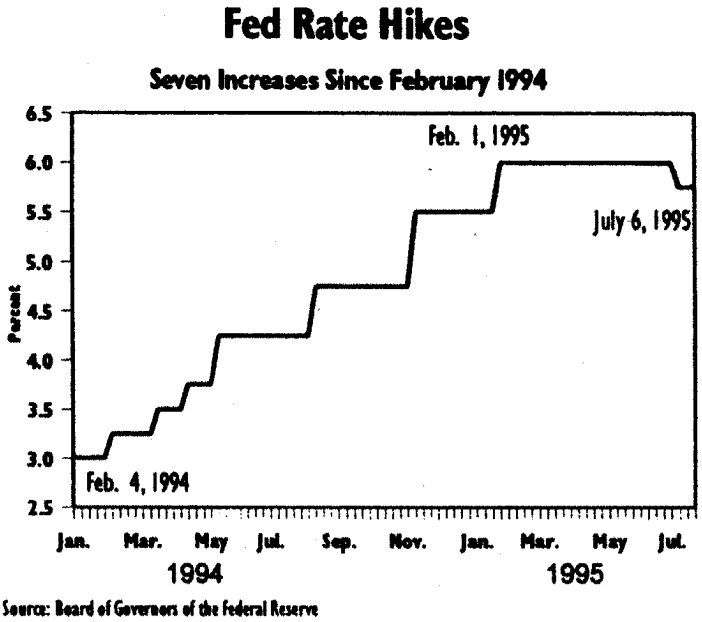
In addition, during 1993 and 1994 the number of jobs on non-farm payrolls rose by 267,000 per month. This was five times the rate of job growth under the Bush administration and about double the post-war average. As a result, the unemployment rate fell from 7.1 percent in January 1993 to 5.4 percent in December 1994. By the end of 1994, the economy was performing close to its long-run peak. The Clinton administration had substantially accomplished the goal of restoring the economy from its poor performance under the Bush administration.

Although wage growth is still inadequate, as we mentioned at the start of this report, the precipitous decline in real average hourly earnings under the Reagan and Bush administrations has stopped and a small increase has been recorded under the Clinton administration. During the Reagan administration, real earnings fell at a rate of 0.1 per year, followed by a steeper decline of 1.0 percent per year during the Bush administration. By contrast, since January 1993, real wages have risen 0.3 percent per year. This is not yet good enough but at least we have turned the corner.

But not everyone was happy about the improvements in the economy.

Monetary Policy and the Economic Slowdown. As the economy strengthened during 1993 and 1994, the Federal Reserve reacted by tightening monetary policy and raising interest rates. This was done, according to the Federal Reserve, to head off inflationary pressures before they could gather steam. As Figure 2 shows, the Federal Reserve increased the target Federal Funds rate from 3.0 to 6.0 percent in seven steps between February 1994 and February 1995.

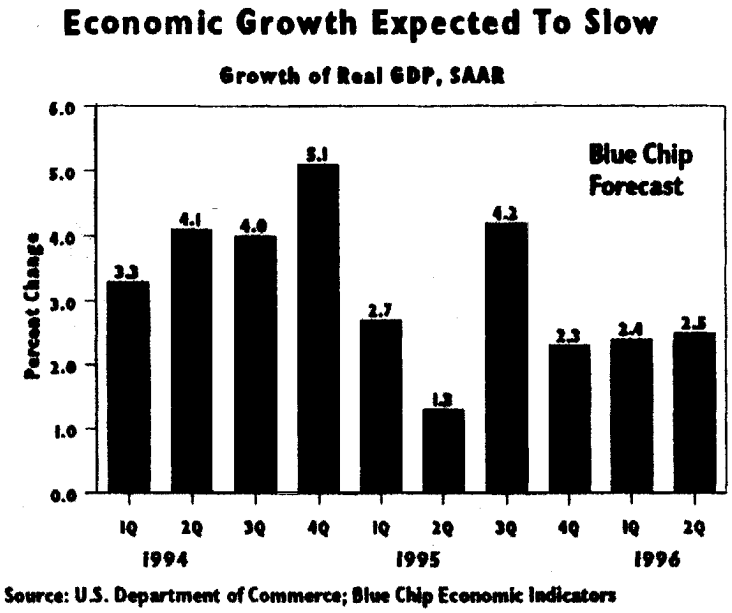
Figure 2



This was one of the largest and most rapid increases in the Federal Funds rate engineered by the Federal Reserve during the postwar period. It was unprecedented for a time of low and falling inflation. Research by the Joint Economic Committee showed that whenever the Fed raised the Federal Funds rate by 3 percentage points or more within a 12-month period, the economy would soon go into a recession. Of course, such an increase would not necessarily cause a recession—many other factors also contribute to recessions—but the fact that the Fed was willing to take the chance indicates the strength of its desire to slow the economy.

The data for 1995 show that the Fed has substantially succeeded. So far this year, the economy has grown at an annual rate of 2.7 percent compared to 4.1 percent last year. And as Figure 3 shows, the consensus of economists calls for slower growth to continue into 1996. The rate of new job growth has also declined to an average of only 135,000 per month this year, or about half the rate of job creation during 1993 and 1994.

Figure 3



1993 Deficit Reduction and the Economy. This slowdown in economic growth during 1995 was not the result of Clinton administration policies, as the Republicans are so eager to claim. Republicans often suggest that the tax increases on the wealthy in the 1993 budget accord caused the slowdown. In fact, at the time Congress was considering the Clinton deficit-reduction program, the Republicans shrilly forecast that it would precipitate a dreadful recession. Quite the opposite actually occurred. Many economists have concluded that the reduction in the Federal deficit contributed to the strong growth last year by helping to lower long-term interest rates during 1993. During the six quarters following the budget agreement, economic growth averaged a robust 4.0 percent annual rate, about one-third faster than the average growth rate in the post-war period.

In testimony before the Joint Economic Committee, Federal Reserve Board Chairman Alan Greenspan explained how the 1993 budget agreement actually helped strengthen the economy:

> The actions taken last year to reduce the federal budget deficit have been instrumental in creating the basis for declining inflation expectations and easing pressures on long-term interest rates. * * * What I argued at the time is that the purpose of getting a lower budget deficit was essentially to improve the long-term outlook, and that if the deficit reduction is credible, then the long-term outlook gets discounted up-front. Indeed, that is precisely what is

> happening. * * * I think a substantial part of the improvement in economic activity and the low rates of inflation can be directly related to a changing financial expectation that we might finally be coming to grips with this very severe problem (January 31, 1994).

Is there any evidence that the tax increases on the wealthy in the 1993 deficit reduction package were responsible for the recent slowdown in the economy? The answer is no.

The most compelling evidence to support this notion would be a significant reduction in spending on products purchased predominantly by upper-income households, such as luxury automobiles and higher-priced homes. The facts, however, show just the opposite—spending on luxury cars and higher-priced homes actually rose after enactment of the 1993 deficit reduction program.

According to "Ward's Automotive Report," sales of luxury automobiles during the first six months of 1995 were nine percent higher than during the comparable period of 1993. By comparison, total car sales were up only two percent, while sales of less expensive small cars were down by sixteen percent. This rise in sales of luxury cars is precisely the opposite of what would be expected if the Republican claims about the 1993 deficit agreement were correct.

In the housing market, the same pattern prevailed. According to the Census Bureau, sales of new homes with a price of $200,000 or more were up eight percent during the first five months of 1995 compared to the first five months of 1993. By contrast, sales of new homes priced $150,000 or lower were down over the same period by almost three percent. Again, this pattern is just the opposite of what the Republicans would predict.

A recent survey of economists by Blue Chip Economic Indicators also provides compelling evidence that the Republicans are barking up the wrong tree. When a panel of 50 of the nation's top economic forecasters was asked to list the factors that are most likely to hold down economic growth in 1996, the top two responses were (1) the lagged effect of past and possible future tightening of monetary policy and (2) the Republican's own government spending retrenchment efforts. Other factors mentioned were the continuing high level of consumer debt and lower demand for new homes and consumer durables. None of the responses by any of the panelists suggested, or even hinted, that the 1993 deficit reduction program would be a likely cause of slower economic growth.

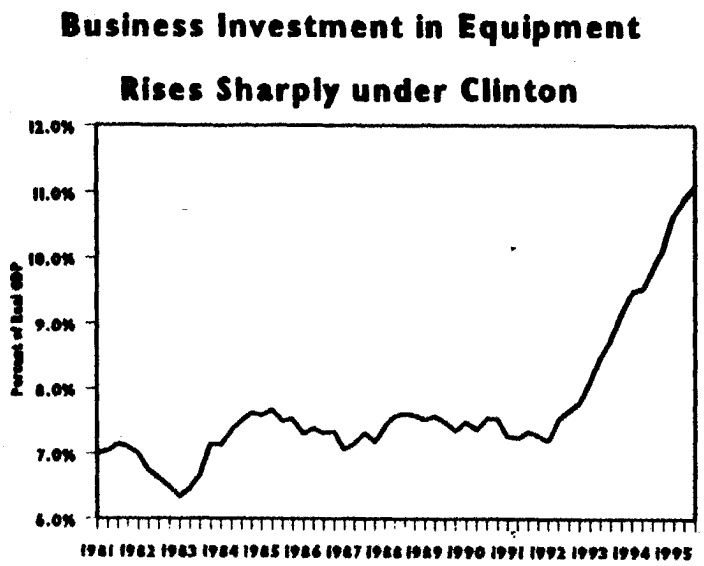
The Republicans also held that the 1993 program would reduce investment in new plant and equipment by cutting invectives for the wealthy to save. Again, they were wildly off the mark. Under Clinton, business spending for equipment has soared to new records, as Figure 4 shows, while spending for structures has also recovered somewhat from the lows of the Bush years.

Lacking both evidence for their charges and support from the community of professional macroeconomists, Republicans' efforts to blame the 1995 slowdown in the economy on the 1993 deficit reduction program is little more than a smokescreen to justify the Republicans' own radical economic policies.

Instead, the virtually-unanimous consensus among economists who follow broad movements in the economy, both in academia and on Wall Street, is that the slowdown in the economy this year was

caused by the increases in interest rates engineered during 1994 and early 1995 by the Federal Reserve.

Figure 4



Source: U.S. Department of Commerce, National Income and Product Accounts

Just as the Fed's policy of raising interest rates has resulted in a slowdown of economic growth, a policy of reducing rates would stimulate stronger growth.

A Time for Lower Interest Rates. On July 6, the Fed carried out a small one-quarter cut in the Federal Funds rate. Two factors contributed. First, there were signs during the spring that the economy was in danger of slipping into recession. Many of the important economic indicators did, in fact, turn negative during the second quarter, raising a warning signal that the Fed may have overshot as it raised interest rates last year. Second, inflationary pressures appeared to be easing. An inflation scare during the first few months of 1995 passed uneventfully. This provided an opportunity to cut the Federal Funds rate, as the Federal Reserve explained in its July 6 press release.

> As a result of the monetary tightening initiated in early 1994, inflationary pressures have receded enough to accommodate a modest adjustment in monetary conditions.

The July 6 rate cut appears to have averted a recession. Growth in the third quarter was 4.2 percent, which represented a significant step up from the second quarter performance of 1.3 percent.

But the most recent economic data indicate that the economy may be weakening again and that interest rates may still be too

high. Recent data for both inflation and growth suggest that another rate cut soon would be an appropriate course for monetary policy.

We find the same absence of inflationary pressure that the FOMC noted when justifying its rate cut in July. During the past year, prices at the consumer level have risen 2.6 percent—the first time in three decades that inflation has stayed below 3 percent for four straight years—while producer prices have risen only 2.0 percent. Labor cost pressures are also virtually non-existent, with the employment cost index still trending downward. At the same time, unit labor costs have risen just 0.3 percent, well below the recent inflation rate.

The growth indicators also suggest that the Fed has kept interest rates too high for too long, particularly in light of recent signs of weakening in manufacturing, housing and retail sales.

In manufacturing, where cyclical changes in the economy often have their most striking impact, there has been a slowdown during 1995. Industrial production in manufacturing has grown at an annual rate of less than half a percent so far this year, compared to 7.2 percent during 1994. With capacity rising at an annual rate of 4.3 percent, output could grow substantially faster without threatening inflation. Since March the number of jobs on manufacturing payrolls has fallen by over 250,000, equivalent to losing one Fortune 500 firm each month for the past 8 months. Recent surveys by the National Association of Purchasing Managers reinforce the impression that manufacturing is growing too slowly. This important sector of our economy clearly needs the lift of a rate cut.

The housing sector has also weakened this year in response to the high interest rates, with housing starts down 8 percent so far from last year's rate. New home sales are off 2 percent from last year. In October, total spending on residential building after inflation was down 4.0 percent from a year ago. This sector could also use a boost from lower interest rates.

Another indicator that gives us some concern is the current weakness in consumer spending and retail trade. Smoothing out the volatile monthly movements, we can observe a dramatic slowdown. Retail sales for the last three months stood only 3.2 percent higher than the level for a year earlier, virtually no gain in real terms, while some early December figures show an actual decline from a year ago.

On Tuesday, December 19, the Federal Open Market Committee recognized the need for a cut in interest rates and reduced the target for the Federal Funds rate by 25 basis points. The Federal Funds rate is now half a point below its peak level at the start of this year. Although this latest cut in interest rates was welcome and appropriate, recent trends in economic indicators suggest that the Federal Reserve should remain ready to make further adjustments in rates if the economy continues to soften.

DANGERS OF THE REPUBLICAN BUDGET PLAN

"Taxes are what we pay for civilized society."—Justice Oliver Wendell Holmes, Jr.

"Don't tax you, don't tax me, tax the fellow behind the tree."—Senator Russell Long.

". . . especially if he or she is a low- to moderate-income worker."—Republicans' 1995 addendum to Senator Long.

Cutting taxes is part of the overall Republican assault on government. The Republicans' common refrain, that cutting taxes lets people keep more of their own money, reveals a deep disdain for the services that the public expects the government to provide. Democrats do not share that disdain. We recognize that government provides services that the private market cannot do as well and that those services must be paid for by taxes. We Democrats want taxes as low as possible but we recognize that, as Justice Holmes explained, taxes are the admission price to "civilized society."

Whether taxes should be as low as possible to cover the costs of government is not a substantive issue between the two parties. Rather, the two fundamental economic debates between the two parties concern (1) the form of taxes to be imposed and (2) the choice of services that government should provide to assure a 'civilized society.'

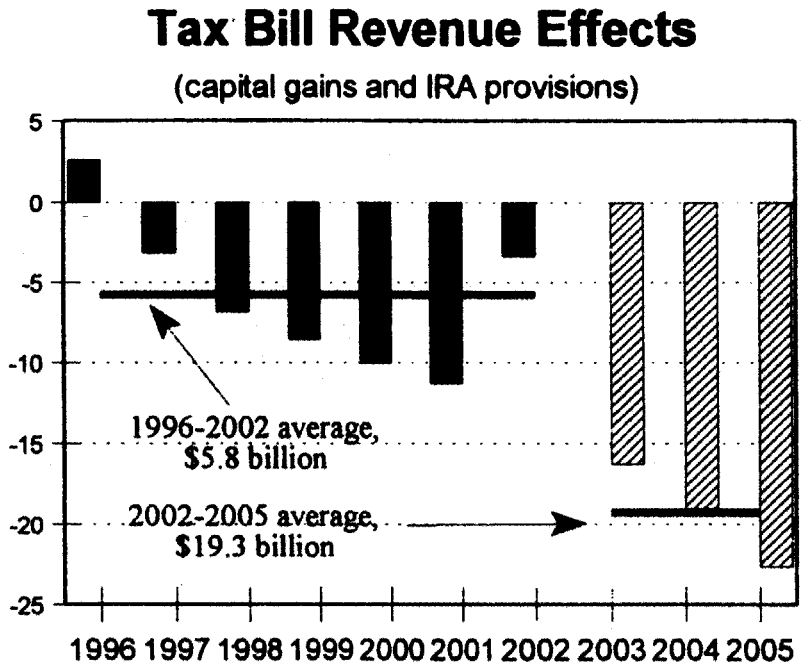
This chapter will examine the tax proposals and spending cut proposals in this year's Republican budget. It will show that, in each case, these proposals fail the acid test: they do not permit more Americans to share in economic prosperity but instead benefit only the privileged few.

REPUBLICAN TAX PROPOSALS

Even Republicans recognize that people do not buy national defense at Wal-Mart. Democrats, like most Americans, believe that government has a larger role to play in the economy than just providing national defense. But whatever size government we decide is appropriate, we must ultimately raise enough taxes to pay for what we get. The mistake we made in the 1980s was to stop paying, but keep spending. The result was large deficits, lower national saving and investment, and mounting debt.

George Bush was right in 1980 when he called the economic rationalization for these policies "voodoo economics." Current Republican tax proposals are deja-voodoo economics. They are bad public policy for at least three reasons. First, they make meaningful deficit reduction harder. Second, they are poorly focused to encourage new saving and investment that will help the economy grow faster in the future. And third, they are highly skewed toward giving relief to high income taxpayers. The net result endangers true deficit reduction.

Figure 5



Tax Cuts and Deficit Reduction. The urge to cut taxes is a major barrier to deficit reduction. It is hard enough to make the substantial cuts in government spending needed to bring the budget into balance by 2002 without having to make room for a tax cut as well. It is no longer possible to pretend that the budget can be balanced simply by eliminating waste, fraud, and abuse. Meaningful deficit reduction requires real cuts in real programs affecting real people. By insisting on large tax cuts, Republicans have had to propose spending cuts that go beyond what most Americans consider reasonable, thereby threatening the public support and political resolve necessary to balance the budget.

The tax proposals in the latest Republican budget are less irresponsible than those in the original Contract with America. Yet they still contain some troublesome gimmicks and ticking time bombs that would lose substantial revenue outside the current 1996–2002 budget planning horizon. Large future revenue losses are especially dangerous in light of Congressional Budget Office projections that the baseline budget deficit is expected to worsen significantly after 2002.

Overall, the scaled-back Contract with America tax provisions in the reconciliation bill would lose $245 billion in revenue over the 1996–2002 period. But they would lose over $170 billion in the first three years after 2002, with mounting losses into the indefinite future. The capital gains and IRA provisions are especially troubling. Figure 5 illustrates how these provisions are structured to obscure

their true revenue costs within the budget planning window, while exploding after 2002. For example, the capital gains indexing provision is structured to provide a temporary revenue increase in 2002, but it loses substantial revenue after that. The IRA provisions start out with a few years of modest revenue losses, but then lose increasing amounts of money. The net effect from these two provisions is an average loss of less than $6 billion per year between 1996 and 2002 and an average loss of almost $20 billion a year over the next three years.

Tax Cuts and Economic Growth. The primary economic objective of deficit reduction is to increase national saving and investment and boost future economic growth. Yet the Republican tax proposals are very poorly focused to encourage new saving and investment. Tax cuts for families and seniors, whatever their other merits, are more likely to encourage consumption than saving. Capital gains tax cuts and other changes generally confer large tax windfalls based on past saving and investment that spur greater consumption while they provide very small incentive effects for new saving and investment. Deficit reduction is generally recognized as far more effective in this regard. It is therefore highly ironic that a tax cut that loses money, adds to the deficit, and increases consumption at the expense of investment should be the "crown jewel" of the Republican program.

We should not repeat a major mistake of 1980s economic policy and exaggerate the impact of tax cuts on economic growth. Economists recognize that a change in the relative attractiveness of work over leisure and saving and investment over consumption increases the incentive to work, save, and invest; when people work more, save more, and invest more, the economy grows faster. But an honest assessment of both the economic theory and the empirical evidence regarding how tax cuts affect behavior suggests that the likely effects are small.

On the theory side, a lower marginal tax rate on labor income means that a worker can keep more of each additional dollar she earns. This makes it more attractive to take a paid job or work longer hours, other things equal. But a higher after-tax wage means she would not have to work as many hours to earn the same amount of income. This makes it attractive to cut back a little on the number of hours worked and enjoy a little more free time or family time.

The same argument applies to saving. A higher after-tax return on saving makes it more attractive to save, other things the same. But a higher after-tax return on saving means fewer pretax dollars need to be saved to achieve the same after-tax savings. This theoretical ambiguity about how taxes affect economic incentives is reflected in the empirical evidence. As summarized in a Congressional Research Service analysis:

> While evidence on the effect of tax cuts on savings rates, and thus, economic growth, is difficult to obtain, most evidence does not indicate a large response of savings to an increase in the rate of return. Indeed, not all studies find a positive response.

The empirical evidence on work effort is similarly ambiguous.

These findings do not suggest that a poorly designed tax system cannot discourage productive economic activity or that a well-designed tax system cannot encourage it. Democrats are not opposed to tax reform or even, when the time is right, tax cuts that would contribute to strong, stable, and shared growth. But they do oppose cutting taxes willy-nilly and justifying those cuts with exaggerated claims about how they will stimulate growth. Such tax cutting is bad economics and bad public policy.

Tax Cuts and Fairness. Republicans are forced to exaggerate the economic growth effects of their tax cut proposals, because the static distributional effects of these proposals are so embarrassingly tilted toward those who are already very well off. This was especially true in the original Contract with America tax cut, but it remained so in the November 1995 Reconciliation Act.

The centerpiece of Republican tax proposals is the $245 billion Contact with America tax cut they awarded themselves, based on slashing spending enough to achieve a balanced budget in 2002. But because they could not balance the budget through spending cuts alone, Republicans enacted a number of revenue raisers. Included in these are troublesome changes in the Earned Income Tax Credit (EITC).

The EITC provides tax relief for low income workers and, until recently, enjoyed widespread bipartisan support. Because the EITC is a refundable credit, part of the savings from the proposed changes are treated as outlay reductions rather than tax increases in formal budget presentations. But in effect, all the proposed changes in the EITC represent a tax increase on low income workers.

The bulk of the tax cut for middle income taxpayers comes from the family tax credit. Although advertised as a tax cut equal to $500 per child, the full tax credit only goes to families with enough income to owe more than $500 per child in income taxes. Unlike the earned income tax credit, which is refundable and provides cash to low income working families, the Republican family tax credit is neither refundable nor usable as a credit against payroll taxes, which represent the primary tax liability of low income working families. Fully a third of the nation's 71 million children live in families that would receive no family tax credit. Another three million live in families that would receive less than the full credit.

Upper income tax payers will gain more from capital gains preferences than from the family tax credit. Some defenders of the capital gains preference argue disingenuously that it is unfair that capital gains subject to tax are not indexed for inflation. In fact, capital gains receive favorable tax treatment now and they would receive even more favorable tax treatment under the Contract with America tax cut. According to analysis by the Congressional Budget Office, the marginal tax rate on wages for most middle class workers is 31 or 32 percent. The marginal tax rate on capital gains for taxpayers with incomes above $100,000 is 28 percent. The Contract with America tax bill would reduce this rate even further, to 19.8 percent.

Capital gains enjoy the further advantage of tax deferred reinvestment. In other words, a saver who earned 5 percent per year

on an ordinary savings account would have to pay taxes on the interest each year and could only reinvest the after-tax interest. Capital gains, by contrast, are only taxed when they are realized. After 10 years, a person with $1000 in a savings account earning 5 percent and subject to a 28 percent tax on interest each year would receive $423 in interest net of taxes if he redeposited his after-tax interest each year. A shareholder with $1 million in stock that appreciated at the same 5 percent would net $453,000 after paying a 28 percent tax on the $629,000 of capital gains that would accrue over ten years. The person with the capital gain would have the higher after-tax rate of return irrespective of the inflation rate.

In addition to the advantages of lower marginal tax rates and tax-free accrual of unrealized gains, capital gains can escape taxation altogether. For one thing, no capital gains taxes are paid on assets that are passed on to heirs and no tax liability is passed on to heirs. In the above example, if the stock market investor died ten yeas after the investment was made, the full $1.629 million value of the asset would pass into the estate and no capital gains taxes would be paid. The financial press has recently reported on an apparently widespread practice of stock-swapping to postpone or avoid capital gains taxes even after gains are realized. Tax preferences for capital gains also encourage people to make inefficient economic decisions that reduce tax payments by converting ordinary income into capital gains. Further widening the differential between the tax rates on capital gains and on ordinary income will encourage more inefficient tax-dodging schemes.

During the 1980s we observed a failed experiment with trickle-down economics. Substantial tax cuts for businesses and high income individuals not only failed to translate into an improved standard of living for most Americans, they also failed to raise the private savings rate. Disappointing trends in the distribution of income and wealth were aggravated by policies that favored the well-to-do. No matter how Republicans try to obfuscate or deny the issue of fairness, Democrats are troubled by these trends and are skeptical that conferring large tax breaks on high income taxpayers will produce economic growth whose benefits are widely shared by ordinary Americans.

REPUBLICAN PROPOSALS TO CUT SOCIAL PROGRAMS

During the decades since the Great Depression, many social programs have been put into place to provide for the economic well-being of the most vulnerable members of our society, including children, the elderly, the disabled, and the involuntarily unemployed. These initiatives include some of our most successful government programs, such as the Social Security system. Programs such as Medicare, Unemployment Insurance, School Nutrition programs and even the Food Stamp Program also receive widespread public support. We believe that few Americans want to see our children and seniors left vulnerable to the kind of destitution and want that many experienced during the Great Depression, before the enactment of this social safety net.

Support for our basic cash welfare program for families with children, the Aid to Families with Dependent Children (AFDC) program, has recently been much less strong, however. Many Ameri-

cans have come to believe that welfare payments undermine recipients' motivation to achieve economic self-sufficiency. Accordingly, many support reforming the welfare system to create a greater focus on moving its recipients off of the welfare rolls and into the workforce.

While the goals of broader social support programs such as Social Security are more widely supported, the Republicans argue that it is necessary to cut back on entitlement programs providing benefits to individuals almost across the board. About 40 percent of the total savings needed to produce a balanced budget by the year 2002 under the Republican plan, for example, would come from the Medicare and Medicaid programs. In all, the Republicans propose to cut $420 billion from these two programs over the next seven years.

How would the cuts in social programs proposed by the Republicans affect families? We believe that they would impose much harsher than necessary reductions on programs for the poor and the elderly, causing real hardship. In addition, by reducing incentives and opportunities to work, by imposing new burdens on low-incomes families with children, and by punishing most severely those seniors with the gravest health problems, these cuts also run the risk of producing very negative unintended results. Some of the worst of these proposals in welfare and in health care, are highlighted below.

Welfare Reform. The need for some reform of the welfare system as it exists today is agreed upon the Democrats and Republicans alike. In the last Congress, President Clinton submitted an ambitious reform plan calling for a complete redesign of the system, and reform of the welfare system has been one of the highest priorities under the Republicans' "Contract with America." Although there are of course differences in the specifics of the welfare plans that have been proposed by the Administration and by the Republicans, there is some consensus that welfare reform should encourage work and personal responsibility while protecting our neediest children and seniors from extreme destitution.

Welfare Reform Under the Republican "Contract." How would the welfare reforms proposed under the Republican "Contract" go about achieving these goals? While the legislation proposed by the Republicans makes many major changes in specific welfare programs and in the welfare system as a whole, the general approach has three important features:

Imposing strict limits on the amount of time people can spend on welfare;

Converting most welfare programs into block grants to states instead of paying benefits directly to individuals and families; and

Restricting eligibility for benefits in a number of programs, including the Food Stamp Program (FSP) and the Supplemental Security Income (SSI) Program for disabled children.

Imposing Time Limits on Welfare Recipiency. The time limits on receiving benefits that would be imposed under the Republican plan would apply only to the Aid to Families with Dependent Children (AFDC) program. Although AFDC is the program that people tend to think of when they think about welfare, it actually accounted for less than 10 percent of the total funds spent by the

Federal government on means-tested programs in 1994. The program provided benefits to an average of about 14 million people per month last year—considerably less than half of the population who lived in poverty. The average benefit in 1994 was about $375 per month for a mother with two children, which would put a family relying on AFDC benefits alone at about 40 percent of the poverty line. Nevertheless, concern about long-term AFDC recipiency has been a major feature of the welfare reform debate for some time, and the Republic plan addresses this concern by proposing a lifetime maximum of five years of benefits for most AFDC recipients.

Are time limits on welfare recipiency a good idea? Proponents argue that if recipients know there is an absolute cutoff date beyond which they cannot receive benefits, they will be more motivated to find and stick with a job and will become more self-sufficient, a major goal of welfare reform. Indeed, the Administration's welfare reform proposals also include some time limits, although poor mothers subject to the limits would be given more help in finding in keeping a job than under the Republican plan.

This help is needed because unfortunately many welfare recipients experience substantial barriers to increase their self-sufficiency. Although more than half of those receiving benefits within a given year also have some earned income, most have very low wages and relatively unstable jobs. A recent study of 2.8 million mothers who received welfare over a two-year period found that although 70 percent worked at least some of the time, their average earnings when employed were just $4.29 an hour. And unfortunately, the jobs that these mothers did get—as maids, cashiers, waitresses, nurses' aides and child care workers, for example—frequently lasted for less than a year at a time and typically did not include health insurance or other benefits.

If such mothers are to become economically self-sufficient without plunging their children even further into poverty, many will need some help in finding and training for a job. Most mothers who enter AFDC leave the program is less than five years, but those with very low skill levels and those who live in high-unemployment areas are likely to be on the program somewhat longer that the average. For mothers who cannot find a job, time limits alone with not increase self-sufficiency. Only if such limits are coupled with programs to provide job training, job placement assistance, and, in the last resort, public jobs, will they allow families to leave welfare for a better economic future.

Unfortunately, the AFDC changes proposed by the Republicans impose time limits on recipients without guaranteeing them access to a job. Funds for existing job training and job placement programs for welfare recipients would be cut, and if states wished to continue these programs they would have to find new ways to fund them. Unlike the existing program, this act offers nothing to encourage or help recipients to find jobs before the expiration of the time limit. And when recipients hit the time limit under this act, they would lost eligibility for welfare whether or not there was a job available for them (unless the state chose to include them in the small number of recipients it would be allowed to exempt from time limits). This bill would not only do nothing to prepare recipients for work or to help them find jobs, in other words, but would

also gut the work programs for welfare recipients that states already operate. If job training and placement assistance are not offered and there no jobs available, strict time limits on recipiency may reduce welfare roles, but at a high cost to poor children and their families.

Converting Welfare Programs to Block Grants. Under current law, most benefits for low income families are provided directly to the families and individuals who are intended to benefit from them. Program such as the Food Stamp Program, the AFDC program, and the Supplemental Security Income program send checks or food coupons directly to qualifying families once they have established their eligibility for the program. All families meeting the eligibility criteria for a given program can apply for and receive benefits, and the total amount paid out each year depends on the number of eligible families that apply. As a result, total benefits paid out tend to go up during recessions, when jobs are harder to find and more families apply, and down during periods of high employment. Programs like food stamps thus provide some buffer for working families when times are bad.

Under the Republican budget plan, however, federal payments for most welfare programs would be frozen at a fixed level in advance, and would be given to each state in an annual "block grant." States would then set their own rules for distributing these funds to needy families. Eligible families would not be guaranteed a benefit, as they are now. If a state ran out of block grant funds in July, for example, people applying for benefits in August could only receive them if the state added more of its own funds to the program. These additional funds would not be matched by the Federal government, as they are under current law, any overrun would be solely the state's problem.

Proponents argue that providing benefits in a lump sum paid to states in advance will prevent welfare programs from growing, as they do now during recessions, and will give states more discretion in designing the programs to fit local needs. Under the House Republicans' welfare reform proposals, however, states are expressly forbidden to provide benefits to certain categories of people, such as teen mothers living alone, legal aliens, and children born while their mothers are on welfare. And because funding is reduced under the block grant as compared to current law, most states will either have to find substantial new funds or cut off benefits to many recipients.

Even more unfortunately, because the block grants are fixed for five years at a time, states with worse-than-average economies during those five years will have to come up with more additional funding (or reduce benefits more), while more fortunate states with low unemployment rates may actually save money on their welfare programs. Substituting block grants for the current funding system would effectively redistribute funding from states with rapidly growing needs to those whose needs are declining. Further, it would undermine the countercyclical nature of the current program. Currently, countercyclical spending on welfare programs in states with declining economies helps to dampen the effects of the recession, encouraging faster recovery. Under a block grant system, spending for benefits would no longer rise automatically in states

that are falling into recession—in fact, as state revenues fell, spending would also have to be curtailed.

Allowing complete state discretion in cutting benefits could also force states to compete with their neighbors to provide the least attractive benefit package in order to minimize their own welfare costs. Eligibility and benefit levels could vary even more from state to state than they do now, and states which contributed substantial funds to their welfare programs would run the risk of attracting additional beneficiaries from less generous states.

Finally, while increased state discretion may work to improve some programs, there is some evidence that states may not always be better than the Federal government at identifying needs and meeting them. Among the programs that would be turned into block grants under the "Personal Responsibility Act," for example, are child protection programs such as Foster Care and Adoption Assistance. Currently, 29 of the 50 states are operating their child protection programs under court orders, because the courts found their existing programs inadequate. Removing all federal standards for child protection programs could leave abused and neglected children at even greater risk.

Restricting Eligibility for Benefits. A major argument for introducing block grants in AFDC and related programs has been that states need more discretion in running these programs. However, in many cases savings would be achieved under the Republican welfare plan by introducing more Federal restrictions on program eligibility. States would no longer be allowed to provide benefits to certain categories of disabled children, for example. Teenage parents could not receive benefits unless they lived with their own parents. States would generally be prohibited from spending funds on families who have been on the rolls more than five years, no matter what their circumstances, and benefits could also be denied to all children born while their mothers were on welfare—again, no matter why. These and other restrictive mandates to states have been opposed by many, including right-to-life activists who believe such rules may provide greater incentives for abortions. In any case, such restrictions on state actions do not seem consistent with an argument that states need greater flexibility and freedom in administering their welfare programs.

Although cutting off benefits to long-term welfare recipients is the feature of the Republican welfare bill that has received the greatest attention, it is not the source of the greatest cost reductions. In fact, most of the savings over the next seven years would result either from denying benefits to immigrants, legal or otherwise, or from implementing new measures to restrict benefits under the Supplemental Security Income (SSI) program for severely disabled children.

Cash payments now received by severely disabled children in low income families would be eliminated for all new recipients except those who are so disabled that their families would have to institutionalize them in the absence of a cash payment. Some of those now on the program would also lose their cash benefits. A set of reduced block grants would be given to the states, with instructions to provide medical services and equipment such as wheel chairs for these children. States could choose to divide this money up any

way they want—there is no guarantee that all or even most low-income disabled children in the state would be served under the block grant. In fact, just about the only thing states wouldn't be able to do with these funds is give them directly to low-income families with disabled children.

The reasoning behind this new set of restrictions is that under the old SSI program for disabled children some children may have been "coached" to behave badly and to make their disabilities seem worse then they really were. Republicans argue that eliminating cash benefits would make it less attractive to try to game the system this way.

Many studies of this issue have been carried out, both by the Social Security Administration and by private groups, and all have found that the incidence of such fraudulent benefits claims in SSI is very low indeed-—less than 2 or 3 percent of all cases. Rather than address this problem directly, however, the Republicans have chosen to throw the baby out with the bath water by denying benefits to thousands of very severely disabled children whose families are struggling to maintain them at home, against very heavy odds. In the long run, this not only creates major hardships for these children and their families, but is likely to cost even more money, as low-income families give up the struggle and place their severely disabled children in publicly funded institutions.

Health Care Cuts. Although welfare programs are widely believed to need some reform, our health care system currently provides a high standard of care. President Clinton's proposals to extend that care to the uninsured and to hold down the rate of increase in medical care costs were opposed and defeated by the Republicans last year, with the argument that the changes would lessen individual control over health care decisions and reduce the quality and accessibility of care. Nevertheless, without proposing any specific health care reforms nor any safeguards to protect the availability and quality of care, the Republican budget as passed in the Reconciliation Act would cut the Medicare portion of Social Security by $226 billion over the next seven years.

Medicare Cuts. Under the cuts proposed in the Republican budget, the Medicare program will be almost 20 percent smaller in 2002 than it would be under current law. Although these are very large changes, the Republicans have done little to safeguard the quality and accessibility of care for Social Security recipients if such draconian cuts are enacted.

The Republicans argue that their proposals aren't really cuts, just reductions in the rate of growth for Medicare spending. They argue that even spending per person will go up. What they don't mention is that people's medical needs will be rising even faster, so that Medicare recipients will be left with ever-higher out-of-pocket medical costs to pay. To see how misleading the Republicans argument is, we have only to look at the factors behind the projected spending growth.

The Republican argument makes it sound as if Medicare is expanding every year, in the sense that people are becoming entitled to new services or that new people are being served or that doctors and hospitals are having a higher share of their costs reimbursed. None of these things is true. The cuts the Republicans want to

make would come out of the amount that would be needed just to keep benefits and reimbursement rates comparable to those of today.

Medicare costs are projected to increase over the next seven years, of course—and so are all other health care costs. Spending increases in Medicare are projected to occur at about the same rate as in other health care spending—unless the Republicans succeed in cutting the share of health care dollars going to Social Security recipients under Medicare.

What's behind these rising health care costs? These costs go up over time for a number of different reasons. Two of the most important are:

New technologies are invented—saving lives but also increasing the number and cost of services that may be provided to patients.

The population is aging—so that more people are falling into the age groups where they are likely to need more medical services.

What do the Republicans propose that we do to prevent such cost increases? Tell Medicare patients, "Sorry, you can't have that new test for cancer, because it wasn't invented when Medicare agreed to pay your health care costs, so it's not covered in your insurance?" Are doctors supposed to check before they use new technologies or prescribe new drugs to make sure that the patient has supplemental insurance to pay for it—because Medicare can't pay for health care improvements? Will we tell our seniors, "Sorry you're not allowed to be any sicker this year than you were last year—Medicare can't cover the costs of growing older?"

Few would advocate such a policy. And yet, that is just what these Republican proposals amount to—cutting the Medicare program so that it no longer comes close to covering the health care costs of Social Security recipients as well as today. Under these proposals, Social Security recipients would pay $3,500 more apiece for their health care out of their own pockets over the next seven years. Out-of-pocket costs for seniors will rise by more than $1,000 in 2002 alone. Almost 83 percent of Medicare benefits go to seniors with less than $25,000 per year in total income. How are such people going to pay these additional health care costs?

And the additional payments that would be required from Social Security recipients aren't even the whole story. If reimbursement rates for doctors and hospitals under Medicare are also cut, it will be increasingly difficult for seniors to get access to quality medical care. Rep. Archer—the Republican chair of the House Ways and Means Committee—raised this issue last year with regard to much smaller proposed Medicare cuts. He said, "I just don't believe that quality of care and availability of care can survive these additional cuts." Just what do the House Republicans think is going to happen to the quality and availability of care for Social Security recipients under their much larger proposed reductions in Medicare spending?

Recently some Republicans have argued that it is necessary to cut Medicare in order to save it—cuts that would have been unthinkable in better times are needed now to prevent the Medicare Trust Fund from being exhausted. It is true that the Medicare

Trust Fund now looks shakier than it did in the recent past—partly because of Republican changes that reduced taxes on higher income Social Security recipients, which had been earmarked for Medicare. But the cuts in Medicare proposed by the Republicans go far beyond what is needed to maintain the Trust Funds over the next several years. And in fact, many of those cuts would have no direct impact on Medicare solvency at all, because they would affect a part of the Medicare program that is not financed through the Hospital Insurance Trust Fund, the fund that is now in trouble. The real point of the large cuts in Medicare called for by the Republicans is not to help the Trust Fund, but rather to pay for a larger tax cut that will mostly benefit the well-off.

In the long run, it is necessary for us to control the rate of increase in health care spending. But the way to do that is through a comprehensive plan that addresses health care spending as a whole—not through a series of massive cuts that unfairly target those receiving Medicare.

Cuts in Medicaid. The Republicans are also proposing to cut more than $130 billion over the next seven years out of the Medicaid program for poor and medically needy families. This would reduce the program by more than one-fourth compared to current law by the year 2002. Again, the Republicans say they are just holding spending down—not really cutting. And again, this is very misleading. Under these proposals, poor and near-poor people who qualify for Medicaid will get fewer medical services then they get now.

The Republicans do not specify which medical services they're going to cut, or which poor people won't receive services. Instead, they are proposing to turn the whole program into a set of block grants to states, but with substantially less funding than the states would need to maintain current Medicaid services. That leaves the entire problem up to the states, who will be caught in a no-win situation. Either they can stop providing services altogether to some poor Medicaid recipients, or they can further restrict which services poor people in general will receive. Most states will probably have to do some of each.

Like the block grants proposed for the AFDC and SSI programs, the Medicaid block grants would be fixed in advance for a period of time. If a state experienced unusually hard times, causing higher unemployment and loss of private medical insurance, its Medicaid allocation would simply have to be spread over more people. No more funds would be available from the federal government, and presumably state tax revenues and other income sources would also be falling at the same time. States would be left with the choice of refusing medical services to needy children and seniors, or running up deficits in their own budgets. Meanwhile, states with higher levels of employment would simply get to keep the windfalls that they would experience as the result of fewer than expected demands on publicly funded health programs. Does it make sense to put so many burdens on states that are already in economic difficulties, while allowing large budget windfalls to states lucky enough to have booming economies?

WHO WOULD BE HURT BY REPUBLICAN BUDGET PROPOSALS

As the last section discussed, Republican proposals in both the tax and spending areas pose significant dangers to the American economy and to American society. Overstating the impacts of tax cuts on growth, as the Republicans have consistently done, allows them to give tax breaks to high-income Americans without facing the impacts these cuts will have on the budget as a whole. Reducing spending by cutting aid to needy children and seniors without providing adequate child care or job training programs will simply increase the hardships suffered by poor Americans without helping increase their self-sufficiency. For moderate income families, the proposed spending cuts are likely to mean higher health care bills, more spent on day care, less money for college, a more uncertain retirement, and a larger share of family income and assets being eaten by the costs of aged parents' long term health care needs. And all of these changes would come on top of an existing set of income trends that already strongly favor the rich at the expense of middle and lower income families. This section examines those trends and discusses the impacts of the Republican proposals in light of them.

Trends in Income and Poverty. Over the past two decades, household income in the United States has grown much more slowly than it did in the period between World War II and 1973, and the growth that has occurred has been much more heavily concentrated among those at the upper end of the income distribution. Between 1948 and 1973 average income (adjusted for inflation) approximately doubled, since 1973 average income has risen only 13 percent. In the 1950s, 1960s, and even in the 1970s, incomes up and down the distribution grew at approximately the same pace as average income. More recently, however, incomes at the top of the distribution have grown faster than the average, while incomes in the middle and bottom have grown more slowly.

Poverty Rates. In 1994, 38.1 million Americans, 14.5 percent of the U.S. population, were officially classified as poor. Poverty level income varies according to family size and composition. For example, an elderly widow living alone is counted as poor in 1994 with income less than $7,100, but a family of four (mother, father, two children) is poor if their income is less than $15,109.

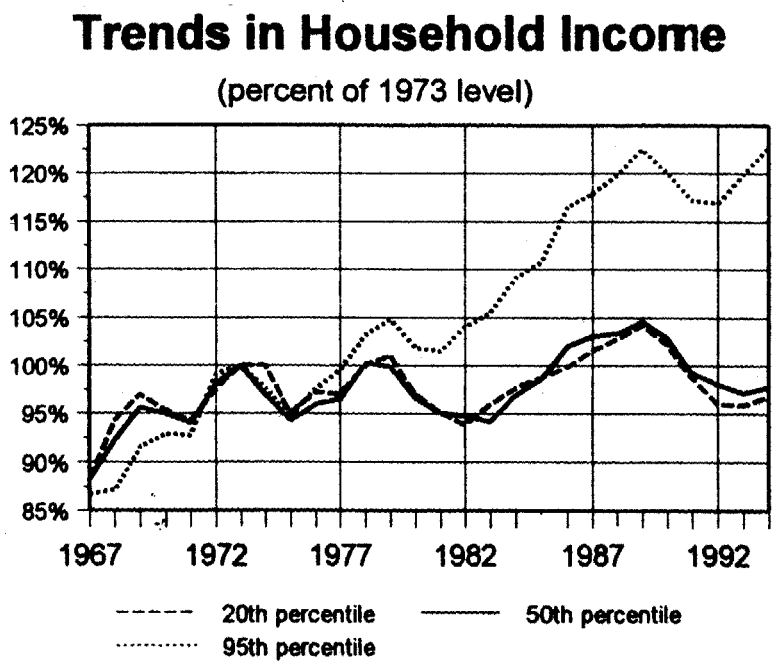
Both the poverty rate and the number of poor people in the United States remain high today by the standards of the past twenty-five years. The poverty rate at the last business cycle peak, 1989, was 12.8 percent, and almost 7 million fewer Americans were poor. The rate was 11.4 percent in 1978 and 11.1 percent in 1973. Since 1990, in contrast, the rate has remained over 13 percent, peaking at over 15 percent in 1993. Although 1994 poverty figures show some improvement, there has been very little progress against poverty over the last decade as a whole.

Family Income. Medium household income has also lagged recently; it was just $32,264 in 1994. The median is the midpoint of the distribution: half the households in the country had incomes below $32,264 and half had incomes above $32,264. For families at this midpoint, there has been little growth in real income over the past two decades. Income at the midpoint of the distribution was

actually 2.2 percent lower in 1994 than it had been in 1973, and real income levels also fell over the entire distribution below the midpoint. By contrast, income at the 95th percentile (the dividing line between the richest 5 percent of households and everyone else) was up almost 23 percent. In other words, poor households and low income working households were worse off in 1994 than their 1973 counterparts, whereas the highest income households were substantially better off.

Wages. Wages constitute the bulk of income for most families, and wages show the same trends as incomes. Average wages have grown much more slowly over the past twenty years than they did in the earlier postwar period and the distribution of earnings has become more unequal.

Figure 6



Average hourly compensation approximately doubled in the 25 years between 1948 and 1973, but it has risen only 7 percent in the 22 years since then. Unlike the income measures discussed above, the compensation measure includes fringe benefits. One broad measure of the money wage of ordinary workers, the real average hourly earnings for production and nonsupervisory workers, covers four-fifths of the nation's workforce. This measure took a nosedive over the past fifteen years, falling from $12.48 an hour in 1978 to $11.12 last year (measured in constant 1994 dollars). Other measures of labor costs confirm that fringe benefits have increased more rapidly than money wages over the same period. Average money wages for the other fifth of the workforce (those in adminis-

trative, professional, and technical jobs) have done better than the hourly earnings measure.

As with the income data, averages conceal large differences between what is going on at the top of the distribution and what is going on with everyone else. Studies of wage inequality have found the same tendency toward rising inequality that shows up in the household income data. They also tend to show failing wages for workers at the middle and bottom of the wage scale, with the bulk of earnings growth concentrated in the upper reaches of the distribution.

What's Behind the Trends? A slowdown in productivity (output per hour) after 1973 is the main reason for slower growth in average wages and incomes. But no consensus has emerged to explain the productivity slowdown or why despite productivity gains real wages continue to fall. Nor are the causes of rising inequality in incomes and earnings particularly well understood. Analysts point to technological change, increasing international competition, lower unionization, and a falling real minimum wage as factors that have reduced the earnings potential of some kinds of workers while raising that of others. On balance, however, economists have no simple or fully worked out analysis of how changes in wages and incomes and their distribution interact with complex underlying structural changes in the economy.

Government tax and spending policies do not appear to be the primary cause of slow wage and income growth. However, well-targeted investments in the health, education, and training of workers, in roads, bridges and other public infrastructure, and in generating new knowledge through R&D can enhance productivity. Cutting such government investment programs hurts productivity, and hence wages and incomes, unless those cuts translate into greater and more productive private investment. And further, cutting programs such as education and training that are most likely to help lower-income workers get a leg up and improve their situations makes little sense in a time when income inequality is already growing.

Similarly, government tax and spending policies do not appear to be the primary cause of rising inequality. This too stems from underlying structural changes in the private economy. Nevertheless policy changes that make the tax code less progressive or reduce the value of transfer programs like Medicare or food stamps exacerbate rather then offset any underlying tendency toward greater inequality in market earnings. Because that trend is already so pronounced, policies that will further exaggerate it should face close scrutiny.

Impacts of Republican Budget Proposals on Families at Different Income Levels. Unfortunately, there is little doubt that the Republican budget policies will further exaggerate current trends toward increasing inequality in incomes. In order to meet its goals of goals of balancing the budget by the year 2002 while also cutting taxes, the Republican majority in the Congress had to find over $1.2 trillion in budget savings over the 1996–2002 budget planning horizon. Some of these savings may come from cutting waste or improving efficiency, but most will come from cutting programs that provide real benefits to real people. In some cases, these cuts rep-

resent a direct loss of cash or benefits by identifiable people (increase out-of-pocket medical costs for seniors, for example). In other cases, the loss is more intangible, less direct, or harder to measure (less basic research generating fewer new ideas, for example). And, of course, those at the top of the income distribution who get a tax cut end up with more after-tax income even if they receive fewer program benefits.

A recent study by the JEC Minority Staff confirms that the Republican plan will cost the poor and benefit the rich. Budget cuts that effect people directly will fall disproportionately on families with below-average incomes, while the tax cuts will accrue disproportionately to those with above-average incomes.

The 20 percent of families with the lowest incomes will bear half the program cuts. (See Figure 7) They will experience average losses of more than $2000 per family by the year 2002. To add insult to injury, many of these families will face higher tax bills as well.

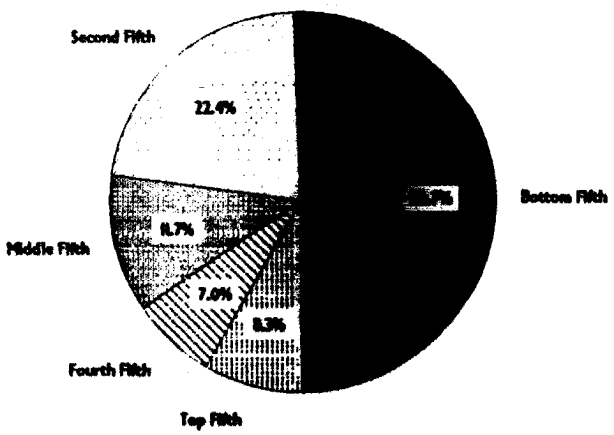
The 20 percent of families with the highest incomes will bear less than 9 percent of the program losses, while reaping nearly two-thirds of the total tax cut. (See Figure 8) They will gain tax benefits worth almost $1000 per family in 2002 while incurring less than $400 per family in program cuts.

Because of cuts in the Earned Income Tax Credit, the bottom 20 percent of households will face a small net tax increase. The middle 60 percent of families will lose direct program benefits of nearly $600 per family on average in 2002, but will receive a much smaller tax cut—about $200 per family in that year.

Figure 7

Percentage Distribution of Spending Cuts

Fiscal Year 2002



Source: JEC Democratic Staff Calculations from CBO data

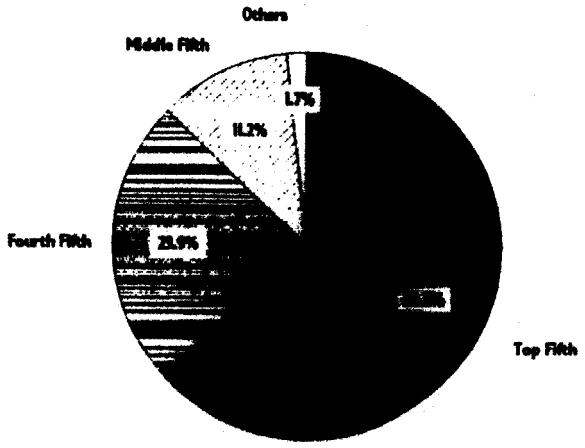
These overall net impacts do not tell the entire story, of course. Specific families within each income category will experience different actual losses or savings. In general, the working poor, low-income people with major medical expenses, and retirees will be the biggest losers, while those with high unearned incomes will gain the most.

And, because this study allocates all of the proposed tax cut in 2002, but only part of the savings from reductions in spending, it probably over-estimates the net benefits to families that will occur as a result of these changes. Cuts affecting health care providers, local school budgets, bridge and highways funds and so forth cannot be allocated to people in any particular income category with any degree of certainty, but many of these cuts will also have a negative effect on the quality of people's lives.

Figure 8

Percentage Distribution of Tax Cut

Fiscal Year 2002



Source: JEC Democratic Staff Calculations from CBO data

Reducing the budget deficit cannot be a painless exercise—sacrifices will be required. But these sacrifices do not have to come so disproportionately from those at the bottom of the income distribution, nor is it necessary that those at the top be asked to do so little. Historically, we have had a somewhat progressive Federal tax and expenditure system, with the burdens of paying for government rising as the ability to pay rises. But even a proportional distribution of the costs of bringing down the deficit would look very different from the Republican plan.

For example, if every family in the country were asked to make sacrifices equal to the same share of their incomes to reduce the deficit, a contribution of less than one percent of income would be required from each family to match the $64 billion of deficit reduction from individual benefit cuts and tax changes in the Republican plan for 2002. Under such a plan, those in the lowest fifth of the income distribution would lose less than $100 in income and benefits in 2002—not the $2200 they will lose under the Republican plan. And those in the top fifth of the distribution would pay about $1300 more, instead of getting an average net windfall of almost $1000 as under the Republican plan.

Some Republicans argue that very high income taxpayers deserve a larger share of any tax cut, because they have been paying a growing share of total taxes. But the reason that the tax payments of the well-to-do have risen over the past decade is largely that their incomes have also risen. Because almost all of the income gains of the last decade have gone to higher-income house-

holds, they naturally have had to pay a larger share of total taxes. The proportion of income paid in taxes by those in the top 20 percent, however, is just about what it was in 1980.

Republicans imply that the market will take over all the important functions that the government will be giving up under their proposals, and no doubt some functions will be replaced by the private sector. But markets respond only to the demands of people with money to spend. The Republican tax and expenditure cuts will help to ensure that people at the top of the income distribution have an even larger share of our total spending power than they do today. As a result, the needs of lower and middle-income Americans in basic areas such as health care are likely to remain unmet.

What Should We Do? Alternative Policies to Aid Low Income Workers. Rising inequality has been a hallmark of the past decade or more. This is bad for our society in a number of ways.

First, it is divisive. When the gap between rich and poor grows too wide and increasing numbers of people feel that America is no longer a land of opportunity for them, the social fabric of the country is at risk. Those at the bottom may begin to feel they have less of a stake in the continuity and growth of our society.

Second, too much inequality hinders economic growth. As those who are less well-off get poorer and fall farther behind, their access to education and training and their opportunities for improvement tend to be reduced. And in the end that means that the nation as a whole is less well-off because growth of the U.S. economy is held back by a less qualified workforce.

Third, abandoning those who are less well-off just isn't the American way of doing things. America has been and must continue to be a land of opportunity for all Americans, not just for the lucky few at the top of the income ladder.

Income gains to those at the top are to be applauded, but more needs to be done to make sure that low- and moderate-income workers also see some income gains. A number of policies could be implemented to make sure that income gains are spread fairly across the whole distribution of income, and not experienced only by those at the top. Two of the most important—and in some ways, the easiest to implement—would be increasing the minimum wage and investing in the education and training of American workers.

The Minimum Wage. One factor in the falling relative incomes of lower income families and workers has been the decline in the real value of the minimum wage. Today, a minimum wage worker who works full-time, year round, does not earn enough money to keep a family of two out of poverty. Until the early 1980s, the minimum wage was high enough to keep the average three-person family out of poverty.

The Fair Labor Standards Act (FLSA), originally enacted in June 1938 under President Roosevelt, established a minimum wage of $0.25 an hour, effective October 24, 1938. Since then, under Presidents Truman (1949), Eisenhower (1955), Kennedy (1961), Johnson (1966), Nixon (1974), Carter (1977) and Bush (1989), the FLSA has been amended to raise the minimum wage. Though the minimum wage has been raised sporadically, until 1981 it consistently fell between 45 and 55 percent of the average wage of nonsupervisory and production workers. When President Reagan became the first

elected President to fail to increase the federal minimum wage since its establishment, it fell to below 40 percent of the average wage of nonsupervisory and production workers.

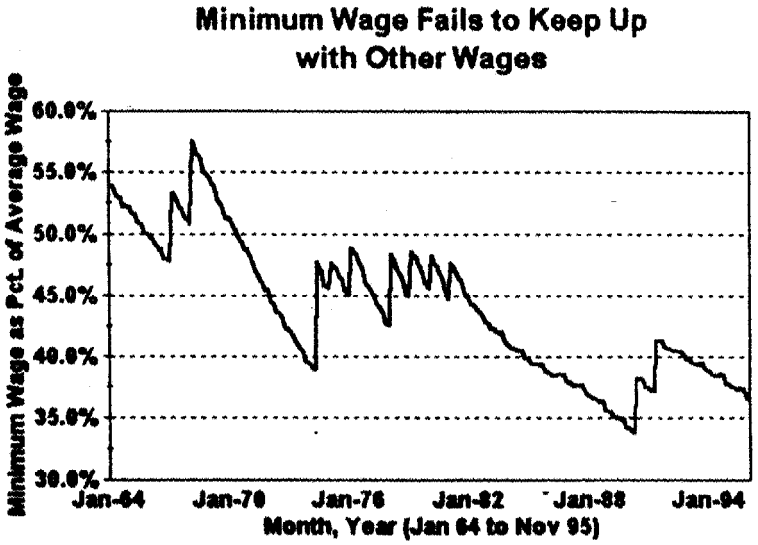
Because the minimum wage sets a floor for wages that had been changed to keep pace with other wages in the economy until the 1980s, those at the bottom of the wage distribution gained along with other workers until then, as Figure 9 shows. Since then, however, low-wage workers have increasingly fallen behind.

The negative effects of the falling value of the minimum wage goes beyond just those workers making the minimum wage or close to it. The JEC Democratic staff has identified a set of jobs whose wages change with the minimum wage, in contrast to jobs where wages seem to move with changes in other wages in the economy. Workers in the first set of jobs are said to be on the "minimum wage contour," or "MWC." Holding down the value of the minimum wage depresses the wages of workers on the MWC.

Workers whose skills and other characteristics seem similar to those in minimum wage contour jobs, but who have the good fortune to hold non-MWC jobs, make around 30 percent more.

In other words, even after extensive information related to productive capacity is examined, there remains a 30 percent wage gap between those holding MWC jobs and comparably productive workers holding non-MWC jobs. One reason could be that MWC workers have fewer options to give them bargaining power with their employers. For example, the ranks of the minimum wage work force are disproportionately female, and discrimination against women workers remains in the labor market.

Figure 9

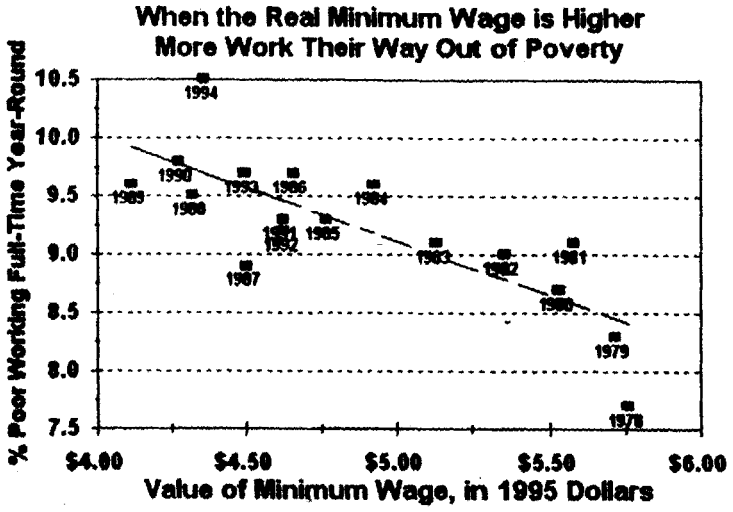


When the minimum wage rises, some balance is restored to the equation and low-wage workers are made relatively better-off. When we increased the minimum wage from $3.35 in 1989 to $4.25 in 1991, the wage gap between minimum wage contour and non-minimum wage workers shrank. Also, the gap between the wages of women and men shrank.

Because many employers link the wages they pay to the minimum wage, the fall in its value has also meant declines in other wages for low-wage workers. One result of falling wages at the bottom of the earnings distribution has been a rise in the share of families with children living below poverty. Figure 10 shows the relationship, from 1978 to 1994, between the value of the minimum wage, and the share of the poor who work full-time, year-round.

The years when the real minimum wage was higher were also years with a lower share of full time workers making incomes below the poverty line. For instance, the highest value of the minimum wage during the period shown in Figure 10 was in 1978 when the minimum wage was worth $5.76 an hour in today's dollars. That was also the year the share of the poor who worked full-time, year-round was the lowest, 7.7 percent. Conversely, the highest share of poor workers working full-time, year-round was 10.5 percent in 1994, when the minimum wage was at one of its lowest values.

Figure 10



The reason the minimum wage is so important in figuring the number of workers who are poor is because it affects the earnings of many low-income families. Minimum wage workers are often misperceived to be predominantly teenagers or middle-income women earning extra money. However, most minimum wage workers today are adults with substantial attachment to the labor market, 74.4 percent are adults, and 47.2 percent are full-time workers.

The relationship between the minimum wage and the ability to use work to escape poverty suggests a net positive effect on income of a higher minimum wage. It would appear that the higher earnings of low-income workers under an increased minimum typically more than offset any losses from decreases in total employment. The Report of the Minimum Wage Commission, looking at studies through 1979, showed that any negative effects on total jobs of increasing the minimum wage were limited to teenagers. Studies that include data from the 1980s show an even smaller job-loss effect than previous studies.

As the purchasing power of the minimum wage falls, the share of the work force receiving the Earned Income Tax Credit and/or benefits from means tested entitlement programs such as the Food Stamp Program rises. Failure to increase the minimum wage to keep pace with other wages, therefore, also increases demands on the Federal budget. Using the minimum wage and the EITC together to insure that working families avoid poverty, as has been done since 1975, means that when the purchasing power of the minimum wage falls, the size of the EITC must rise. The sharp drop in the real value of the minimum wage has also increased demands from working families for help with health, nutrition, and other needs.

Largely because of changes in the EITC, the average federal tax rate (income, payroll, and excise taxes) for families in the lowest fifth of the income spectrum declined from 10.4 percent in 1985 to 5.1 percent in 1994. Even as their before-tax income has been falling, the working poor with children have enjoyed a significant offsetting gain from the EITC. The Republican budget proposals would remove many families from eligibility for this crucial protection for working families, and increase the marginal tax rate for others. The bill would also roll back provisions adopted by Democrats in 1993 to expand the EITC.

The President has proposed, and legislation has been introduced in the House and Senate by Democrats, to increase the minimum wage from $4.25 to $5.15 in a two-step, two-year process. At two JEC hearings on this issue early this year, several points emerged.

(1) Most economists find no significant difference in the effect of changing the minimum wage on the employment of African American youth compared with white youth.

(2) Economists are less certain of the effects of the minimum wage on employment; and

(3) Estimates of potential job loss resulting from minimum wage increases have gotten smaller.

Surprisingly, there was agreement on this last point between economists asked to testify by the JEC Republicans and Democrats. The testimony of two economists invited by the JEC Republicans was particularly interesting.

Dr. Daniel Hamermesh (University of Texas—Austin) said:

> * * * I have argued in the press that I would be happy to see the minimum wage raised by a small amount and then indexed forever, so in the future you and your successors haven't got to waste your time and the public doesn't have to waste its time worrying about this issue.

Dr. David Neumark (Michigan State University), coauthor of an April 1995 article published in the "Journal of Business & Economic Statistics," said:

> A striking feature of most of these studies (including ours) is that simple comparisons, or regressions controlling for exogenous shifts in labor demand, do not reveal disemployment effects of minimum wages for teenagers.

As even the Republican witnesses agreed, therefore, a reasonable increase in the minimum wage to allow it to keep pace with average wage gains would have few negative consequences for employment. Passing this legislation is a simple step that we can take now to improve incomes for low-wage workers and their families.

Education and Training. Equalizing the pay of equally qualified workers is one way to address growing income inequality. Another way is to address inequality in training and education levels among workers. There has been a growing gap between the earnings of more and less educated workers. There has also been a growing gap in the employment of more and less educated workers.

Among industrial nations, the U.S. has under invested in labor market policies aimed at training workers, getting young workers into the labor market, and supporting workers who lose their jobs with income maintenance. Our expenditures on labor market programs (including training, income maintenance, and others) for workers who are displaced or at risk of being displaced are much lower, as percentages of gross domestic product (GDP), than those of most other industrialized nations such as Germany or Canada.[2]

Labor market policies in the United States are not as prepared to handle shifts in industrial structure, as happens for other industrial nations. U.S. spending on labor market policies reflects the type of shift U.S. public policy is designed to handle—cyclical downturns. U.S. labor market policies have not been designed to address shifts in technology or trade.

Education, employment and training programs are public investments. They have positive returns many times their expense. For instance, while one year of Head Start costs $5,400, participation in Head Start increases the earnings over a child's adult work life of $696 a year. So it is not surprising that a study by an economist at the Richmond Federal Reserve Bank shows that federal dollars spent on education, employment and training increase GDP, and by more than investment in physical infrastructure or defense.

A bipartisan effort in Congress, following the lead of the President with his "G.I. Bill for America's Workers," has tried to bring the American training system up to date. The proposed legislation, now in conference, does this by consolidating and refocusing many education and training programs. Those are movements in the correct direction to make the programs more efficient. Still, however well intended these efforts are, the reduced funding for education and training proposed in the Republican House and Senate appropriations for education and training undermine the programs' effectiveness.

---

[2] This can be verified from the data on public expenditures on labor market programs in Organization for Economic Co-operation and Development (OECD), "Employment Outlook," July 1991, pages 239, 241, and 249.

Cuts of more than $700 million have already occurred in employment and training programs because of the fiscal year 1995 rescission. The House appropriation for education and training for fiscal year 1996 is a cut in program level, in nominal dollars, from the reduced fiscal year 1995 level. Thus, because these cuts ignore the effects of inflation and growth in the youth and displaced workers needing assistance, there will be a significant reduction in the number of workers and youngsters served.

For instance, the elimination of the Summer Jobs program for youth will mean more than 600,000 youth will not find jobs this summer. Other job training programs for disadvantaged youth will be cut 54 percent compared with the fiscal year 1995 appropriation level. The House proposes cutting dislocated worker assistance 34 percent below its fiscal year 1995 appopriation level. As a result, 193,000 fewer workers will be helped finding jobs. Because those programs function as block grants to states, there are no savings of administrative costs to be realized, these are simply reductions in the number of youngsters and workers America will be investing in.

In education, the House proposes to reduce Title I grants for disadvantaged students in fiscal year 1996 by $1.1 billion below the fiscal year 1995 level. More than $2 million in cuts from fiscal year 1995 are proposed in the fiscal year 1996 appropriation for adult literacy. These programs represent necessary investments in bringing those the farthest behind in our economy up to a level playing field.

Clearly, the Republican appropriations reflected in their budget, exacerbate both the under investment America is making in its work force, and the income inequality that is stifling low income Americans. The Republican's disinvestment in low-wage and less-educated workers, given the difficulties those workers have in the current labor market, contrasts with the agenda of the President and Democrats in Congress to positively address these problems.

CONCLUSION

Starting in 1993, Democrats laid the economic policy foundation for solid growth that ended several years of economic recession and stagnation. Compared to January 1993, we have 7.8 million more jobs and unemployment down from more than 7 percent to 5½ percent.

For the longer term, Democrats have also pursued policies to strengthen ordinary working Americans' earnings which have languished for more than two decades. Democrats expanded public investments in training and education which take time to bear fruit in higher earnings. We expanded the Earned Income Tax Credit (EITC) to assure that those who work full time can escape poverty.

The new Republican majority has proposed an economic agenda in 1995 that would dramatically change priorities in ways never discussed during the elections of 1994. Many programs that assist low to moderate income working families (such as the EITC) would be scaled back sharply. In addition, those least able to fend for themselves, the elderly and children, would suffer some of the deepest cuts in federal assistance. Meanwhile, Republicans are in-

sisting on massive tax cuts for which the benefits would flow primarily to those already prospering.

The elections of 1994 brought back divided government and ignited a debate over some fundamental differences in economic policy. That debate promises to continue at least through the elections of 1996. We Democrats are confident that, after comparing the priorities set by the Democrats with those set by the Republicans, the public will favor the policies set by the Democrats.

○