An Economic Forecast and Policy Prospects

➢ The economy is stagnating today because everyone is waiting for someone else to restart the recovery. Consumers are deferring major purchases until job prospects are rosier. Businesses are pushing down their inventories and payrolls until their order books surge. In essence the economic fundamentals are sound, but at this point, we need a new catalyst for recovery.

It is time to implement policies that directly stimulate investment including a self-financing equipment tax credit for productive equipment purchases, adjustment of Federal Reserve and Treasury market activities in order to lower bond rates, initiation of a bounty for scrapping old cars, and the channeling of a higher proportion of public funds to public investment in health, education, science, and advanced infrastructures.

by Roger E. Brinner

The forces that brought the U.S. economy to its present condition were set in motion by policies our government followed and external shocks we endured. Some of these forces have shifted gradually over the past decade, others more recently—and now they are changing again.

The seas have changed for the military complex and for builders of retail, commercial, and office space. New policies took expenditures from troughs in the late 1970s to peaks a decade later; these changes are typical of the ten to twenty-year cycles, based on major strategic shifts in national priorities that have always been present in our economy.

These and other recessionary forces have commanded the most media attention, while the contrary, positive cycle of export success has not been fully appreciated. The export boost to domestic production has in fact been much greater than the combined restraint of the shrinking military and construction sectors; from 1987 to 1991, goods exports (measured in 1987 prices) rose by over $500 per capita, while military purchases and nonresidential building construction each fell only about $75 per capita.

Meanwhile tight credit and the energy-and-war shock from Iraq added further recessionary impetus. Once the economy got slightly past full-employment in 1987, the Fed applied the financial brakes. The real estate boom fueled by lending excesses went bust. To this vulnerable situation, Saddam Hussein added his global shock. Also, the standard, cyclical retreat of housing, autos, and machinery spending already underway intensified, with each of these sectors shrinking by $100-125 per capita between early 1990 and early 1991.

However, by late summer, an initial recovery seemed to have been pretty well defined. Unfortunately, when the media turned from the foreign to the domestic front last summer, they found a half-speed recovery in progress. With high drama attached to the potential Republican loss of the White House, print and broadcast journalists focused on the negative economic indicators they found in the mixed picture typical of cyclical change. And positive numbers were reported as "below what was expected." The result was an autumn crash in consumer confidence—a crash unwarranted by the economic fundamentals.

Short downward cycles in autos, housing, and machinery are

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usually cured by easier credit, given that tight credit is the basic cause. However, to minimize the risk of inflation, the Fed chose to administer only small doses of ease. In many circumstances, this may have worked; in 1991, it was too chancy. There was too much gloom around newsrooms, kitchen tables, and boardrooms to yield to moderate signs of help. Quicker, more dramatic action was needed.

Underlying all of these movements has been persistent growth of national income. However, three areas of spending stand out as absorbers of much of this growth: medical care, local governments, and computers.

Medical care is the most striking, rising from $900 per capita in 1970 to $1350 in 1980 and $1700 in 1990. These represent only the inflation-adjusted gains, reflecting an aging population, ever more sophisticated treatments, unbridled legal and administrative overhead, and patients insufficiently motivated to act economically. We predict no near-term change in these forces.

Local government must deliver a blend of necessities and luxuries, and this set of services has grown dramatically through the past two decades and since the 1982 recession. This is how we have chosen to spend publicly a major portion of national growth.

Finally, the computerization of American business has been proceeding apace since the early 1980s. Computer and office equipment now absorbs over $250 per capita of real spending power, but unlike the other booms of the 1980s, this one adds to our national productive capacity.

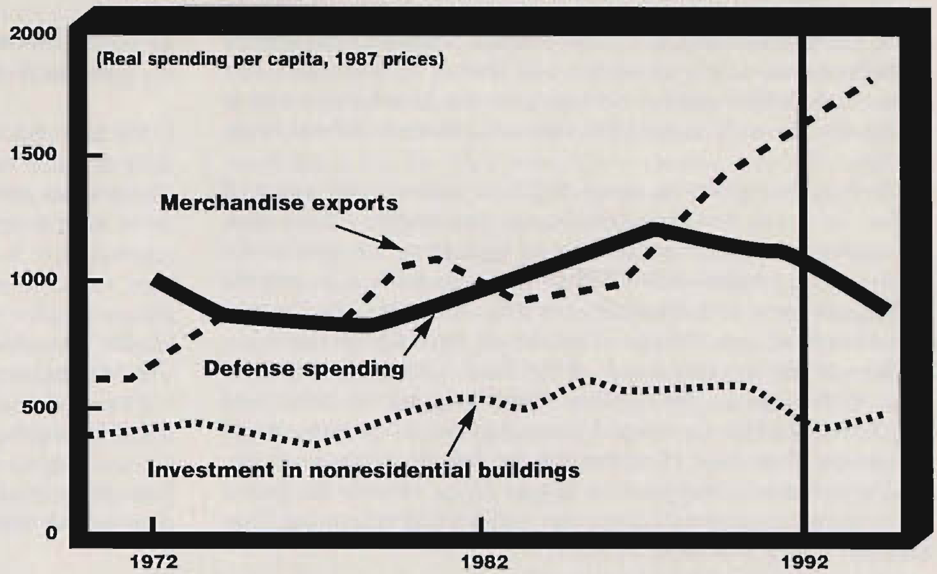
A combination of positive forces should be enough to restart the recovery this spring. Housing construction should continue to rise at close to a 10 percent annual rate as it has for the past two quarters. Exports may rise less rapidly, but strong markets in Latin America and Asia should add to further share gains in the weaker European nations to keep overseas demand moving upward. Finally, President Bush and Congress will work to accelerate their spending and ours into the first half of this year.

The President's Plan

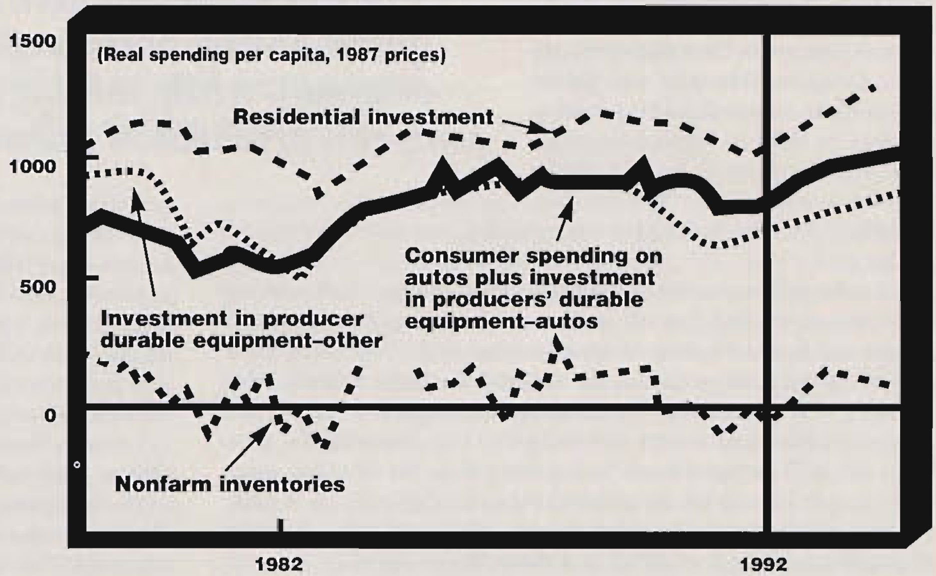
President Bush and his advisors implicitly accept this forecast framework. The 1993 Budget envisions the economic ship-of-state at the bottom of a wave, rather than on a falling tide. Were it not for the forthcoming election, the State of the Union Address could well have omitted almost all of the President's short-run shifts. But the election looms, and the Administration had to buy an insurance policy for growth and re-election.

Several persistent presidential themes can be identified. First, the budget accord is to be covertly deflowered this year but respected thereafter. Spending can be accelerated and taxes postponed, but the structural deficit is not

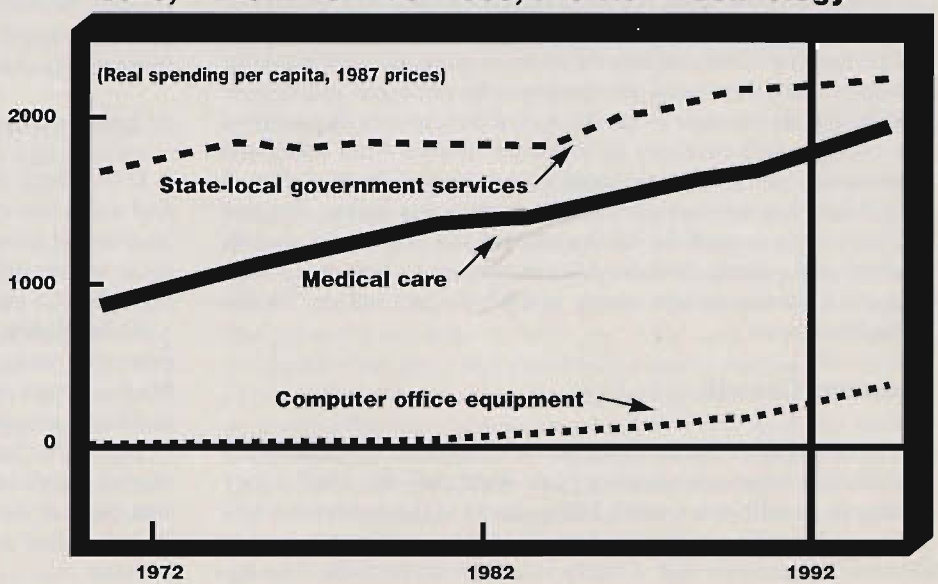
A Long, Rising Wave of Export Opportunities Offsets Defense and Construction Declines



Short Cycles Persist in Autos, Housing, Machines, and Inventories



Trend Growth in National Income Is Spent on Medical Care, Government Services, and New Technology



to be increased. Second, government is too big and the market is preferred. Thus, health reform will utilize existing private institutions but with new insurance coverage possible for vulnerable citizens; education reform and transportation programs shift toward incentives rather than mandates; and freezes on regulation and nonmilitary federal employment are in order. Third, real estate is apparently the only sector that deserves generous federal intervention.

The President offers an array of gifts to almost every group of voters: for young first-time homebuyers, tax credits; for the middle-aged, easy access to IRA savings, higher tax exemptions for children, and interest-deductibility for college tuition; for retirees a pledge to leave social security benefits untouched and for conservatives of all ages, the sacred vow to cut capital gains taxes.

There is real merit in much of the President's long-range program. Unfortunately, the election element tipped the balance of tax initiatives heavily toward consumption at the expense of investment. Intentions of restraining the deficit are praiseworthy, but the initiative with by far the largest dollar value is the executive order to cut personal income tax withholding schedules. Treasury Secretary Brady must reduce excessive withholding of personal income taxes, closing down what amounts to a forced savings plan. Twenty-five billion dollars of these interest-free loans from taxpayers are to be foregone this year and thereafter, unless over-withholding is reinstituted in 1993 or beyond. In addition, opening up IRAs will drain national savings, while new housing subsidies will divert funds from retooling America for the 21st century.

Right now the ideal policy initiatives should give a quick-hitting boost to the economy while adding to long-run production potential.

If the President wanted prompt bipartisan action, he should not have waved the red flag of drastic capital gains tax cuts in the Democrats' faces. These cuts have nothing to do with curing our immediate cyclical problems. No entrepreneur with a functioning memory will accelerate capital spending plans if a 15 percent maximum rate is somehow legislated in 1992: knowing the past, he or she will expect the cut to be reversed in the next five years or so, just in time to tax the value that has finally built up. A capital gains cut perceived to be temporary only encourages churning of portfolios, giving a windfall to owners of old capital.

Congress may pass close variants of the President's housing help, IRA assault, relief for real estate investors, and tax cut for children. However, there are deep partisan differences over most of the long-range program.

The Federal Reserve has its role to play. Chairman Alan Greenspan has expressed his dismay with projected multi-hundred billion dollar deficits for the rest of the century. But interest rate changes will continue to be keyed to short-term economic performance rather than to broad dimensions of fiscal policy. If the tax cuts are not enough to boost growth this spring, the Fed will cut rates regardless of the size of the deficit; if growth resumes as expected, the federal funds rate can be expected to rise from a 3.5 percent winter trough to 6-6.5 percent within the following two years.

Restoring Growth

Unfortunately, politics, not economics, has been the centerpiece of the administration's recovery plan. Right now the ideal policy initiatives should give a quick-hitting boost to the economy while adding to long-run production potential. This combination is only achieved by policies that directly stimulate investment. The following are among the best of such policies open to America at the moment:

1. A self-financing equipment tax credit for productive equipment purchases (SFETC).

We must retool the United States in order to compete successfully in world markets and restore a high-wage standard of living. The greatest spending bang for the tax buck, and the most equitable incentive, can be obtained from an equipment tax credit granted only to firms whose qualifying expenditures relative to their sales exceed a normal national ratio of such equipment purchases relative to gross receipts. Applying the credit only to purchases beyond a threshold greatly reduces the tax costs but provides the full investment incentives for new spending.

The credit, on the proposed threshold basis, may well provide a fiscal free ride: that is, it may generate enough extra national income subject to other taxes that it then funds itself. Note that this differs from the typical "supply-side" view that personal tax cuts pay for themselves. The difference is that a threshold credit focuses the tax break on extra activity, not to investment that would have taken place anyway. The original supply-side personal tax cuts applied to all income, not just to additional hours or entrepreneurial efforts; that is why they could not possibly pay for themselves except in the long-term. Only a tax credit of this type can even come close to providing a free ride.

A traditional investment credit, like the 10 percent ITC we had before the 1986 tax reforms, raises equipment purchases by approximately $1 for each $1 lost to the Treasury. In the short-term, it does not pay for itself to a materially different degree than would personal tax cuts. But a self-financing threshold-based equipment tax credit could well pay for itself, and should significantly boost capital spending. It provides the same price incentive to added investment as a standard credit, although it does not provide as much added cash flow.

The self-financing equipment tax credit will flow through the business community to households in two prominent, valuable channels. First, more people will be employed in high-wage jobs to produce the equipment. Second, lower after-tax costs of equipment will mean lower inflation for capital-intensive industries. As a result, household income will rise by much more than business profits in response to the tax credit.This is definitely not an old-fashioned trickle-down approach to economic stimulus.

2. Lower Bond Rates

Lower bond rates will relieve the credit crunch which has stifled small business hiring and expansion by encouraging banks to lend to the private sector. Instead, banks are now taking the easy route of borrowing at 4.5 percent from their depositors and lending at 6.5-7.5 percent to the government.

As bond rates fall so will mortgage rates; there can be no more powerful tonic for real estate values and construction activity. Finally, lower bond rates will boost share price and lower capital costs will strongly encourage corporate capital spending.

Bond rates can be cut by changing Federal Reserve and Treasury market activities. It is also necessary to convince global investors that the U.S. fiscal "peace dividend" will be applied to the federal budget deficit and not to another round of unaffordable personal tax cuts.

The Treasury should issue fewer long-term bonds, meeting new deficit and rolling over old debts with more bills and notes. The Fed should simultaneously make more of its debt purchases at the long end. With the supply of bonds reduced and the demand increased, the price of bonds must rise; that is, the long-term interest rate must fall.

This will twist the yield curve to a flatter shape. The Fed could help by further loosening, expanding its purchases at all maturities to pull the whole yield curve down. In addition, this strategy could save tens of billions in annual federal borrowing costs.

3. A "Bounty" for Scrapping Old Cars

A national program to take old, heavy-polluting cars off the road would strongly stimulate new vehicle purchases in 1992 and 1993, and would greatly improve air quality. The proposed legislation is modeled on a private, successful pilot program already completed in California.

Briefly, an owner of a 1967-1978 model-year (registered, insured, and driveable) vehicle could choose to turn in the vehicle for a $700 bounty from the federal government in 1992. The program could be repeated every three to five years if desired, but the 1992 bounty would jumpstart the economy. The continuing importance of the auto industry to the U.S. economy is confirmed by the fact that the entire decline in our GNP in the last quarter of 1990 was accounted for by the decline in auto production.

This policy initiative is solid on income distribution, growth, and environmental grounds. It gives predominantly low- and middle-income Americans quick cash beyond the current value of most of these qualified vehicles, encouraging them to spend this on newer cars or other consumer goods. There will be a "trickle-up" effect as some of the bounty recipients buy newer used cars from other people who then buy brand new cars. These purchases will create further multiplier effects on national employment.

It would certainly resuscitate the U.S. auto industry and its employees from their current trauma. Such a program is estimated to add up to 1.5 million additional 1992 sales (10+ percent). DRI estimates the program could be fully financed with a two-cent - per gallon gasoline tax, or any other funding source under consideration for anti-recession measures. The bounty-and-scrap program would net large immediate gains in air quality far superior to the improvement possible from raising CAFE (corporate average fuel economy) standards. The targeted vehicles are 10 to 20 times as "dirty" as new vehicles.

This program has the obvious virtue of burdening neither the public nor the auto and refining industries with heavy costs to achieve the air quality gain.

"Fairness" Is Not Related to Economic Stimulus

None of the numerous proposals to cut personal taxes for middle-class Americans should be enacted. The nation can't afford them. The public knows it. The financial markets know it. Most taxpayers and investors will view such cuts cynically, as shortsighted attempts to please voters in an election year. The popular displeasure will build if Congress tries to pretend there are substantial anti-recession gains from a shifting of the tax burden from the wealthy to the majority voters. Voters want jobs with good pay and a future; they don't want the government to borrow more money to subsidize a quick fix. They also don't want more trickery with hidden phase-outs of their personal exemptions and itemized deductions. This gimmickry provides some of the worst politics for Congress. The pretense is maintained that the maximum tax rate is 31 percent, but the reality is a 34 percent effective federal rate for many individuals and families. Come April, these taxpayers will know they are paying it and will resent Congress's subterfuges. On the other hand, lower income people don't credit Congress for greater "fairness" because they go by the official rates, which suggest little progressivity.

There is no reason to phase out legitimate deductions as income rises. The phase-outs are a back-room political compromise designed to satisfy Democrats who want more progressive taxation and Republicans who don't want to admit in public that marginal tax rates have been increased. The flaw is that the very rich have lower tax rates than many middle-class families. Thus if personal tax codes are to be changed, the Federal government should adopt an honest, new 32 or 33 percent marginal rate in place of the current 31 percent plus subterfuges.

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Quite possibly, some kind of political trade is in the works: a capital gains tax cut in exchange for some variation of the proposed new personal tax credits or larger exemptions. Unfortunately, an exaggerated partisan debate over "fairness" adjustments and capital gains will distract policy-makers from prompt action to help the economy out of recession.

The country has a structural, "consumption-driven" budget deficit from which it should be weaned. We can't afford all the private and public goods and services we're enjoying today; only escalating borrowing makes it temporarily feasible. We won't be able to enjoy these luxuries in future decades, unless we increase national savings by reducing the federal budget deficit and setting new expenditure priorities.

When the economy is back on its feet, it will be time to consider partially replacing the payroll and corporate profits taxes with a value-added tax. We need to share the cost of our government with foreign producers selling here, just as they share their costs of government with U.S. firms. We need the potential stimulant to personal savings and the deterrent to immediate consumption that such a shift could also provide.

We also need to channel a higher proportion of public funds to public investment of health, education, science, and advanced infrastructures. Like business executives, cabinet secretaries must be challenged to fund these by eliminating administrative or low priority expenses elsewhere in their budgets.

After this has been accomplished, then new earmarked taxes could be considered. Note that there is no true peace dividend. Before our collective debt binge of the 1980s, additional borrowing would have been appropriate to fund public investment. But the borrowing has already taken place, paying for the personal tax cuts of 1981 and 1986 and the expenditure programs that were not sized to fit our revenues. We should think of new taxes not as paying for the new investments but as paying for the current programs we can't find the skill or consensus to eliminate in order to fund the required health and education initiatives. The 1980s borrowing is then financing the investments of the 1990s. Only if this balance can be struck can American living standards rise at the attractive rates of the 1960s. C