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3/28/89 p. A1

WHITE OAK, MARYLAND

Labor Letter

A Special News Report on People And Their Jobs in Offices, Fields and Factories

DEMAND GROWS for managers and specialists at service companies.

The problem: filling the jobs. "There's a shortage of qualified people," contends Alan Schonberg, president of Management Recruiters International; "we end up taking people out of Company A and putting them in Company B." Hot areas are health care, data processing and financial services, except securities dealers.

Among retailers, one-third of the merchants surveyed by Management Recruiters plans to add supervisors; only 6% will cut back. Regional banker National City Corp. will hire 125 professionals this year. Ann Barry of consultant Handy Associates sees demand from a wide variety of service companies for "anyone who can make one machine talk to another."

Qualified candidates can insist on top dollars and flexible benefits, Ms. Barry declares.

CLERICAL WORKERS face a darker future; they're supplanted by machines.

Typewriters and file cabinets increasingly are being replaced by computers that can communicate with other computers, eliminating the intervening jobs held by several workers. In all, some 19 million staffers, many of them women, are in jobs threatened by office automation, the National Commission on Employment Policy figures. Billing, filing and account maintenance are among jobs at risk.



A SPECIAL REPORT

Capital Holding Corp., an insurance company, reduced its data-entry department 75% after introducing a computerized system to record and transmit claim information. The Santa Fe Railroad expects its 200-person data-entry department in Topeka, Kan., to be cut as much as 10% a year over the next several years. Some clerical jobs go overseas. "Satellite communication makes it possible to do data processing offshore with just a 24-hour turnaround," says 9 to 5, the working women's group.

JOB HAZARDS are a mounting threat to service workers.

Workplace injuries and dangers—once considered the worry of only construction sites and factories—spread to offices and stores. Wrist injuries triggered by repeated motions, the so-called carpal tunnel syndrome, plague telephone and computer operators. Supermarket checkout clerks using price scanners also fall prey; Kroger Co. tries to make its system easier on cashiers after a complaint from the Occupational Safety and Health Administration about a Dayton store.

Back injuries afflict hotel and motel workers and health-care workers who must constantly lift mattresses or patients. The Bureau of Labor Statistics reports that the rate of injuries and illnesses for hotel and motel workers reached 10.7 per 100 workers. For nursing and personal-care home workers, the rate was 14.2. In the private-sector overall, the average was 8.3.

Stress-related illnesses spiral among social workers burdened with problems like child abuse and AIDS.

SHIFTING GEARS: The Bureau of Labor Statistics expects more auto owners to take their vehicles to dealers for repairs because neighborhood repair shops can't attract enough mechanics with the high-tech training needed for today's computerized cars.

UNIONS COMPLAIN that building owners try to trim costs by bringing in outside contractors to handle janitorial services. The switch leaves workers without job stability and benefits, the unions assert.

RETAIL WORKERS in small companies change jobs more frequently than those in large firms, often because they are part-timers or feel a weaker need to work, says a White House small business report.

THEY'RE SMARTER. Half of all service employees have some college education, compared with fewer than 40% of manufacturing employees, the Census Bureau finds. In business services and medical services, 75% have at least a high school diploma; nearly 60% have some college years.

SERVICE WORKERS, too, bolster exports with their wares.

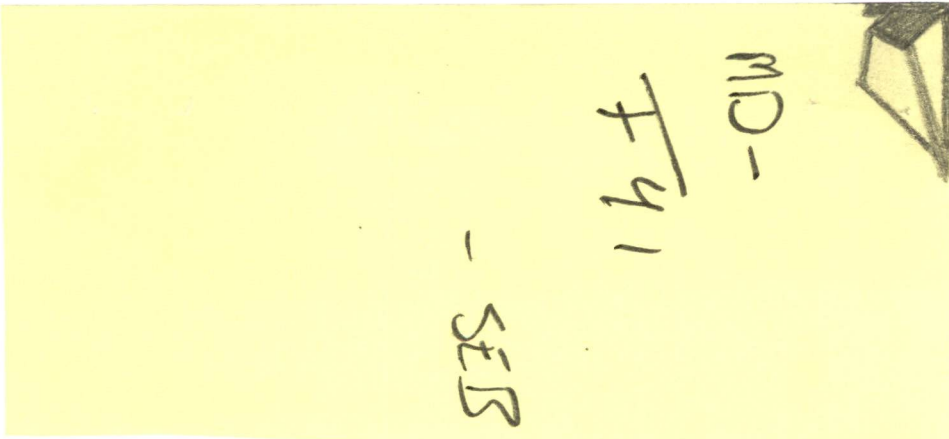
A Chicago lawyer advising a client in France helps the U.S. trade balance in the same way as a company across town that sells a pharmaceutical to Brazil. So does the consulting engineer called in by a manufacturer whose product eventually finds its way overseas. As does the Broadway actor whose performance draws foreign tourists. Case Western Reserve's Center for Regional Economic Issues estimates receipts from such service exports almost tripled over the past decade, to \$90.1 billion.

Airlines, stock brokers, hotels and motion-picture producers are the top service-industry exporters. But the impact varies from city to city. For hotel workers in New Haven, Conn., foreign guests represent less than 1% of business. In Las Vegas, they account for nearly 20% of the trade.

Service firms don't offset lost manufacturing exports but they're "contributing more," Case Western says.

THE CHECKOFF: To cope with the shortage of nurses, ViewNet Inc. offers hospitals an interactive video system that allows patients to order meals and sundries without bothering the staff. . . . Students at Stonestreet Elementary School in Louisville learn the service trade by running a Citizens Fidelity Bank & Trust Co. branch in their school cafeteria.

—CLARE ANSBERRY



Speechwriter
XW



OFFICE OF THE VICE PRESIDENT
WASHINGTON

February 8, 1990

NOTE TO: DAVE DEMAREST ✓
ROGER PORTER
ANDY CARD
JIM CICCONI

FROM: BILL KRISTOL *WK*

Here's a fact sheet on product liability reform that we're distributing, as well as some draft paragraphs on the subject. Both provide material that could be included in various Presidential speeches on the legislative agenda, on competitiveness, to business audiences, etc.

I think this issue is a good one for us, and we've been working effectively with the Hill and the business community. The first hearing in the Senate Commerce committee is February 22, so it would be useful for the President to mention product liability reform once or twice before then.

cc: Chriss Winston



OFFICE OF THE VICE PRESIDENT
WASHINGTON

FACT SHEET ON PRODUCT LIABILITY REFORM

"Product liability reform...it's time to act together."

President George Bush
State of the Union Address
January 31, 1990

"A legislative priority for our Administration will be the reform of our costly product liability laws. The burden of our present product liability system is excessive and adversely affects our ability to compete abroad. In fifteen years, product liability suits have increased over 1,000 percent -- representing unnecessary litigation and extreme costs to American business and consumers alike. This is unacceptable, and our Council on Competitiveness, chaired by Vice President Quayle, has made product liability reform a top competitiveness priority."

President George Bush
February 6, 1990

"Our current product liability system of 50 different State laws generates excessive litigation, inflates insurance costs, and creates uncertainties for American businesses. This is a self-imposed burden on our ability to compete. It also has a chilling effect on innovation and the development of new products. Ultimately, the costs of our inefficient product liability system are borne by American workers and consumers."

Vice President Dan Quayle
November 30, 1989

An Administration Priority.

Product liability reform is a top legislative priority for the Administration. It is essential to business innovation, U.S. international competitiveness, and consumer safety and welfare.

- o In his State of the Union address President Bush called upon Congress to enact essential product liability reform legislation.

- o On November 30, 1989 Vice President Quayle announced the Administration's product liability reform initiative developed by the Council on Competitiveness. The Administration strongly supports S.1400 -- a bipartisan reform bill co-sponsored by Senators Danforth, Inouye, Kasten and Rockefeller and similar legislation in the House of Representatives, and it will seek additional reform provisions to strengthen the bill.
- o The Senate Commerce Sub-committee on the Consumer will hold hearings on S. 1400 on February 22, 1990.

Restore Basic Principles of Fairness.

The Administration's reform initiative will restore basic principles of fairness to America's product liability system:

- o First, protection of an innocent person's legal right to fair compensation for medical expenses, lost wages, property damage and other actual losses.
- o Second, payment for losses based on actual responsibility for the harm -- fault based liability -- not ability to pay -- "deep pocket" liability.
- o Third, cooperation and the prompt and fair settlement of differences should be encouraged through alternatives to costly and time consuming litigation, which only reduces the compensation available to the injured party.

Strengthen U.S. Competitiveness.

Our product liability system --with its excessive litigation costs -- is a self-inflicted burden on America's ability to compete. U.S. product liability laws are more onerous than those of other major industrial countries, such as Japan and European nations.

- o The estimated cost of product liability suits in the U.S. -- \$80 billion per year -- equals the combined profits of the nation's 200 largest corporations.
- o Total U.S. liability insurance costs are estimated to be 15 times higher than Japan's and on average 20 times higher than the European nations'. These costs are reflected in higher prices for U.S. goods and hamper our ability to compete with foreign manufacturers.

Enhance Product Innovation.

Equally devastating is the chilling effect of the liability system on product innovation. The fear of potential law suits deters businesses, especially small and start-up businesses, from introducing new and safer products.

- o Many products are no longer being produced for American consumers -- single-engine aircraft, vaccines against deadly Japanese encephalitis, and gymnastic equipment are a few examples.
- o Many companies decide against introducing new products. For example, Monsanto will not market an inexpensive, safe asbestos substitute and Genentech declined to go forward with a new hepatitis vaccine developed through biotechnology because of liability risks.
- o 36% of American businessmen in a recent survey stated that they stopped some manufacturing as a result of product liability risks. 15% laid off workers and 8% closed plants.

Reform Advances Consumer Welfare and Safety.

Safety and health considerations, the principle rationale for continuing the current system, are undermined by the current product liability regime. Consumers are not always offered new, safer products (like vaccines and the Monsanto asbestos substitute). Also, the costs of excessive liability risks are reflected in higher prices for goods and services.

- o A 1989 Rand Corporation study reveals that on average only 46% of total expenditures from tort law suits went to compensate injured parties. Legal fees and expenses consume on average of 37% of the amount spent -- in some product liability cases this figure reaches 70% of the total amount.
- o The cost of DPT vaccines rose from \$2.80 per dose to \$11.40 per dose to cover liability insurance costs.
- o In a February, 1990 Consumer News article, Bonnie Guiton, Special Advisor to the President for Consumer Affairs states "These are among the ways in which America's current product liability system works against consumers....Done properly, however, product liability reform can benefit consumers..."

The Administration will work with the bi-partisan sponsors of S.1400 and with groups from all sectors of the American public to support U.S. product liability reform that achieves improved U.S. international competitiveness for businesses and restoration of basic principles of fairness for consumers.

For more information contact:
David McIntosh 456-2816

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2/8/90

Suggested Speech Inserts on Product Liability Reform

Reform of our costly product liability laws is a top legislative priority for our Administration. The burden of our present product liability system is excessive and adversely affects our ability to compete abroad. In 15 years, product liability suits have increased over 1,000 percent -- representing unnecessary litigation and extreme costs to American business and consumers alike. This is unacceptable, and our Council on Competitiveness, chaired by Vice President Quayle, has made product liability reform a top competitiveness priority. —

We must restore basic fairness to our product liability system. A person who is injured by a product should be compensated for his or her actual losses. Liability should be based upon whether a person or company is at fault. Individuals and organizations with "deep pockets" must not be made to pay for losses that are not their fault.

You don't need a law degree to know that something is very wrong with a system in which over 50% of the money spent never gets to the injured person. Rather, it is used up in lawyers' fees, court costs, and other legal expenses. That's why I support product liability reform to encourage settlement out of court through arbitration and alternative dispute resolution.

Ultimately, the American consumer pays for the excessive cost of our inefficient litigation system. Companies abandon or severely limit the development and manufacture of important consumer products because of fear of protracted lawsuits and unfair judgments. Product liability reform is needed to preserve the health of Americans who will be worse off when they cannot obtain -- or cannot afford -- vaccines against hepatitis and other deadly diseases. Our kids will miss out on sports, if no one is willing to sell equipment like football helmets and masks. Mothers will not be able to buy car safety seats for their children, if all the manufacturers are forced out of business by skyrocketing insurance premiums. Our office buildings and schools will not be able to replace asbestos with safer products, if the fear of lawsuits prevents their introduction into our economy.

We must act together now. I call for Congress to act immediately to pass needed, bi-partisan product liability reform legislation. We must work together to restore justice, preserve our competitive edge, and promote consumer safety and welfare.



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WASHINGTON

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THE WHITE HOUSE

Office of the Press Secretary

For Immediate Release

March 23, 1989

REMARKS BY THE PRESIDENT
TO THE NATIONAL ASSOCIATION OF MANUFACTURERS

The Mayflower Hotel
Washington, D.C.

1:23 P.M. EST

THE PRESIDENT: Thank you, Dick, and thank all of you. Thank you very much for that warm welcome. Thank you for that warm welcome back. And Dick, thank you, sir, for introducing me and for what you're doing leading the NAM. I want to pay my respects to your president, former secretary "Sandy" Trowbridge, who continues to do an outstanding job. Harry Truman used to say "If you want a friend in Washington, buy a dog." (Laughter and applause.) And I'm here to disagree with him, because I feel in Dick, your chairman, and in "Sandy," your president, and in the membership of this illustrious organization, that our administration has a friend, not only in Washington, but all across the country. And I am very grateful for that and I normally would not dare to speak for our new illustrious Secretary of Commerce, Bob Mosbacher, but in this regard I expect I'm saying exactly what he feels. And I might say to you, the members of the NAM, it is a wonderful thing to have him at my side, a successful businessman, who knows what it means to take risks, knows what it means to try to keep the costs down and knows what it means to add to the productivity of this country. And Bob Mosbacher is already doing a superb job. (Applause.)

After one tough football game, somebody asked Knute Rockne why Notre Dame had lost. And he answered, "I won't know until my barber tells me on Monday." (Laughter.) Well, nobody is second-guessing American manufacturing anymore. And clearly, you all are playing a winning game.

And I'm here today to tell you that deindustrialization that we read about is a myth. And manufacturing, as a share of our national output, is as strong today as it has ever been. And I think many people in this room deserve great credit for that. Thanks to the hard work of you people, who are the brains and the muscle of America's basic industries, were producing more products with a smaller percentage of our population than ever before.

And that, my friends, is productivity. And that is why since 1982, our manufacturing output has gone up twice as fast as Western Europe and has kept pace with Japan. You're the producers -- is somebody's heart beating very fast over there or what the heck is going on? (Laughter and applause.) In the technological age in which we're living I'm sure we can -- (laughter and applause).

No, but you are the producers who are building a better America. And I think that your presence demonstrates that you are fighting to win the international struggle for continued growth. You've demonstrated that you can make America more competitive and that you can keep America more competitive.

So I'm not saying you're going to have to do it alone. There's a role for government. Sometimes political leadership is needed -- for example, to keep international trade free and fair. But I will tell you that this government will not confuse involvement with interference.

And there's a lot of talk about competitiveness going

MORE

around these days, and in a way that's a very good thing. But competitiveness is more than just the latest trade figures, or the latest quarterly earnings -- or the latest poll or the latest election, for that matter.

Surely our success can be measured by better methods than these. This is a good time for us to look towards a larger horizon. And we stand at a special moment in our history. We're prosperous. We are at peace. And at such a point, we've got to set our sights higher. And we must look farther ahead. It's hard for us to believe, but the 21st century is only 11 years from now.

And you've called this conference "The New Leadership Summit." Leadership is certainly found in those like you who keep the great engines of American industry turning. In creating jobs and building businesses and meeting needs, our nation's manufacturers have shown the qualities that will carry us into the future. And make no mistake, the challenges we face will test your vision and your capacity to define an agenda for action.

So today, I'd like to address that very point by outlining my agenda for the next American Century.

To build a better America, one of the most important priorities for this government will be to encourage savings and long-term investment -- to get our fiscal house in order. And that means priority, bringing down the federal budget deficit. (Applause.)

And last month, one of the very first things we did was to submit a budget to Congress with a clear agenda to cut the federal deficit and enhance business' ability to plan, expand, and build. And next year, under current law -- there are no changes in the revenue laws -- the economic growth we are currently enjoying will increase federal revenues by more than \$80 billion without increasing the tax rates. And our plan will hold the line on spending, using some of those new revenues to slash the deficit by more than 40 percent -- and meeting those Gramm-Rudman-Hollings targets.

To encourage long-range investment in businesses of all sizes, it's time that we restored the capital gains differential. By reducing the capital gains rate to 15 percent on long-held assets. (Applause.) And this really is a case where less means more. More revenue to the federal government. The Treasury now estimates that my proposal would bring in \$4.8 billion of new revenues in 1990. That's the Treasury estimate. And the critics all say and have climbed on us in saying "This is a tax cut for the rich." I say cut the capital gains rate and you'll have more jobs for the poor and others. And more growth and opportunity for the whole country. Competitiveness, opportunity, saving and investing for the long-term -- this is why we need a capital gains tax rate cut. And it's why we need one now. And I am going to keep on fighting to see that the Congress gives the people that which they deserve -- more opportunity and more jobs.

To spur investment in basic research, we've proposed a permanent research and experimentation tax credit. We've also proposed a 13 percent increase for science and technology programs, and intend to double the National Science Foundation's budget by 1993 to guarantee that America's technology is number one.

A strong economy needs a safe and secure banking system. And that's why we proposed a comprehensive plan to solve the difficulties of our savings and loan industry and I'm delighted that our very able Secretary of the Treasury, Nick Brady, was over here this morning talking to you about the broad principles of that plan. Frankly, the plan has been pretty darn well-received on both sides of the aisle on Capitol Hill -- and I've challenged -- in my speech to the Congress I challenged the Congress to act within 45 days. This is a matter of considerable national urgency.

We want to ease the pressures now building on the most

important organization in America, the family -- by promoting choice on issues like child care. So last week I sent legislation to Congress that puts money and options in the hands of parents, rather than in the hands of the bureaucracies. And we are going to keep on pushing for that concept. I do not want to have my administration identified with one single initiative that diminishes parental choice or in any way weakens the family. The government must do what it can to strengthen family. (Applause.)

I'd say, though, that the most powerful key -- the most powerful key to long-term competitiveness is education. A strengthened education system is the essential ingredient for America's prosperity into the next decade, into the next century. But no one suggests that education is a minor matter on the national agenda. It is vital to everything we are and can become. Make no mistake about it, I understand the historic role of the communities and of the states, and I understand the limited role that is properly assigned the federal government. So I don't want you to feel that I am moving towards centralizing control over our schools in Washington, D.C.

There are no quick fixes in education. Like most of the long-term issues on the national agenda, American education won't be fixed with a bolt of lightning or a puff of smoke. It's going to take collective effort at all levels, public and private, to get it right. And those businesses that are involved with local schools -- developing the work force at its source -- are making fail-safe investments. And they stand to reap the greatest rewards.

I wish Barbara were here to talk to you a little bit about her interest in literacy and to salute as she does the business community for its involvement. I think this -- I talk about a thousand points of light. And if there's ever an example of that, it is the wide array of business people and business interests that are out there helping in the field of education. I didn't much like it when I talked about a thousand points of light and some cynic around here made some reference, what he really is talking about is a thousand pints of Light. (Laughter.)

But I do salute you for your outreach. For those workers that are already on the line, we must build new skills and flexibility as jobs change, through training and retraining. The NAM policy position that you adopted last year said that "investment in human resources is at least as important as investment in equipment and technology." And you're absolutely right on that one. Machinery and technology alone don't improve productivity. People do.

Another issue where we plan to play for keeps -- we're determined and we are going to keep working at this one -- to get the drugs out of the workplace. (Applause.) Drug and alcohol abuse in the workplace costs \$60 billion every year, putting productivity and lives at risk.

Drug abuse in America really must stop -- and we're off to a fast start. Last month I talked to the Congress about four decisive issues: education, treatment, interdiction, and enforcement. And I asked for an increase of \$1 billion in budget outlays -- to nearly \$6 billion in 1990 -- to escalate this effort. But we'll also be looking to you to set effective, well-reasoned drug policies in your businesses.

Employers can teach their people to recognize the signs of substance abuse in their co-workers -- and understand how drug abuse hurts the non-users on the line.

I've called for a drug-free workplace. And Tuesday's Supreme Court decision, one that just came down the day before yesterday, affirms drug testing. And that's going to give this concept of a drug-free workplace a much better chance of success.

Any long-term agenda must also ask how we can leave the Earth we've inherited a little better than when we found it. And I

was delighted to see Russ Train here, Bill Ruckelshaus here, and I understand they did a first-class job in addressing themselves, with their background of experience, to this question.

We've got to devise answers to the problems of ozone depletion and global warming and acid rain. We've already joined with other nations to call for the elimination of CFCs and the development of environmentally safe substitutes -- as well as adopting a tough new policy on the export of hazardous waste. We can do these things without stifling the economic growth that is necessary, indeed, essential for our nation's economic health.

The time has come to set aside partisan approaches to these and these other enormous environmental questions. We've got to ensure that our grandchildren can fish on the same lakes we've enjoyed.

And in this agenda for the new American Century, I've asked you to consider a broad vision; a vision that relies on the dynamic spirit that is America. The spirit that says buildings should not stand empty, while people lack shelter; jobs should not go unfilled, while young men and women stand idle on the street corners; no one should go hungry in the richest nation on the face of the Earth.

And we must promote local efforts to assure that every American can seize a share of this prosperity -- and help to create more of it -- whether through the constellation of local community groups already at work, or through new ideas, like our program to encourage our nation's youth to become involved in community service. I'm absolutely convinced that with the proper leadership from the White House and across the business community and elsewhere, we can encourage those young people who are more fortunate than some of their peers to pitch in and help those that are less fortunate. We're going to rely less on the collective wallet -- we have to, to do what I told you I want to do on the budget -- less on the collective wallet and more on the collective will.

But this does not mean lowering our sights or our expectations. Just exactly the opposite of that. In the era of tight budgets, we're not going to simply "make do with less." We're going to learn how to do more with less -- and do it better. In the factory, you call it productivity. Across our country, I call it the national spirit.

And, yes, we're a prosperous country and we are at peace. But such quiet moments often become pivotal in the nation's history. The choices we make now are going to determine whether the door to the next American Century is closing or opening wide, for all who dare to dream.

Thank you for your leadership. Thank you for the support of our administration. And aren't we lucky to be living in 1989 in the United States of America, the best, the freest, the greatest country on the face of the Earth? Thank you all and God bless you. (Applause.)

END

1:40 P.M. EST

THE WHITE HOUSE

Office of the Press Secretary

For Immediate Release

March 21, 1989

Barbara and I extend our sincere condolences to the family and many friends of John Jay McCloy. We share your loss. The American people join you in mourning the passing of one of the giants and true heroes of this country.

John J. McCloy helped shape American policy and perspectives during the past fifty years -- in public service and in private life -- as few others have. He was a trusted adviser of American Presidents from Franklin D. Roosevelt to Ronald Reagan. I shall miss the privilege of his counsel. But he also never flagged in pursuing the public good in the many private trusts he held. His energy and interests were boundless. So were his accomplishments.

Recalling his work as chairman of the Ford Foundation, of the Council of Foreign Relations, of the Salk foundation, of the Fund for Modern Courts in New York State, and of the American Council on Germany -- to name but a few of his responsibilities -- one cannot but stand in awe of this great man of humble origins. Not only his talents and experience, but also his dedication and sense of fair play, were rare indeed. We are poorer for his passing. But we as a country are so much richer for having had him with us for 93 years.

John J. McCloy was, not only a prominent American, but also a citizen of the world. He served as President of the World Bank at a crucial time in that institution's history. In later years he became intensely involved with the United Nations Development Corporation.

He was also a pioneer in the field of arms control. In addition to being to being President Kennedy's chief disarmament adviser and negotiator, John J. McCloy served for dozen years as Chairman of the General Advisory Committee on Disarmament Agency. His aim -- which now is the long-established position of the West as well as part a of the declared "new thinking" in the East -- was to establish security at lower levels of armament.

But perhaps John J. McCloy's greatest mark was left by his service in Germany. I know he believed it was among the most important of his assignments. As the United States Military Governor and then High Commissioner from 1949 to 1953, John J. McCloy helped rebuild the economic structure of a nation in rubble, directly touching and assisting millions of Germans living in a country devastated by war. In perhaps his most lasting contribution, he helped establish the democratic tradition of the Federal Republic of Germany and the unbreakable bonds of friendship and solidarity between the German and American peoples.

As Chancellor Helmut Kohl has written of John J. McCloy: "He deserves much of the credit for the high quality of German-American relations which we today take for granted, but which at that time only a trusting friend of our people like John McCloy could see as an objective worth pursuing."

Friend of Germany, friend of Europe, friend of peace, America's friend to the world: John McCloy is a friend who will be missed.

/s/ George Bush

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THE WHITE HOUSE

Office of the Press Secretary

For Immediate Release

March 21, 1989

REMARKS BY THE PRESIDENT
AND SECRETARY RICHARD CHENEY
AT SWEARING-IN CEREMONY

The Pentagon
Washington, D.C.

2:16 P.M. EST

THE PRESIDENT: Mr. Vice President, Members of the President's Cabinet, distinguished Members of Congress, the Joint Chiefs. I am very pleased to participate in the administration of the oath of office to our new Secretary of Defense, Dick Cheney.

This is a proud day for Dick's family -- his wife, Lynne, who heads a vital effort of another sort, safeguarding our cultural heritage at the National Endowment for the Humanities -- and their daughters, Elizabeth and Mary. I also want to welcome Dick's mom and dad, who are here from Wyoming; other family members as well who came to join Dick on this very important day.

Let me outline some of the crucial responsibilities that Secretary Cheney is taking on in his new assignment. Defense strategy and management, procurement reform, the day-to-day operations of our Armed Forces, and the long-range planning that will keep us free and secure into the next century. In a building where it can be a challenge getting from the A Ring to the E Ring without getting lost, the challenges that you'll face, Mr. Secretary, are truly enormous.

Confession time. Dick told me that he's already gotten lost in the garage of this place. (Laughter.) But things can only go up from there. (Laughter.)

The challenges may be enormous, but so, Mr. Secretary, are the skills and talents that you bring to the job. Dick Cheney knows his way around Washington, he knows how things work on Capitol Hill and in the White House, and he'll draw on that wealth of experience to help make things work right here at the Pentagon. Dick and I worked together in the Ford administration on national security issues -- he was White House Chief of Staff and I was Director of Central Intelligence -- and teamwork that paid off then, and he was the best at it.

And, Dick, you'll have help from the best Armed Forces in the world and a civilian staff equally dedicated to our national defense. I know they're ready to work with you and for you.

And I'm convinced the international scene today is defined by opportunity -- a chance to advance America's interests and ideals, and to strengthen the forces of freedom now gaining a foothold in many places around the world. Dick shares my belief that the chief national security lesson of this decade is simply this -- strength secures peace. That fact remains true -- even in the present time of transition in world affairs. Consider the key issue of change in the Soviet Union. I take a very positive view of the changes there, but there are still more questions than answers about the ultimate outcome of those changes.

MORE

And until these questions are answered, we should continue our successful policy of flexibility, combined with strength and firm resolve. We must be ready to seize favorable opportunities to improve relations with the Soviet Union, but we must also remain ready and able in any event to secure our national interests. And let me say clearly, now is not the time for America and its allies to make unilateral reductions to relax our defense efforts.

Everyone here knows that we're facing tough choices on defense programs. We must move ahead with plans to modernize our strategic and conventional forces. We must continue to turn the nation's technological capabilities to our strategic advantage, in SDI and other programs. But our need to deal with the deficit means that we're working with limited resources. And, Dick, your task is to sort out those priorities -- which programs should continue, which we can't afford in the current fiscal climate. I'm convinced these difficult choices can be made in a way that preserves our defense capabilities.

Close cooperation with the Congress is absolutely essential -- and Dick's high standing on Capitol Hill will be an enormous plus.

Procurement reform is a case in point. Our aim should be a more stable and streamlined acquisition system -- but procurement reform can't be confined to the Pentagon alone. We will work with the Congress, our partners in the process, to move forward with the Packard Commission reforms, to adopt a two-year budget cycle, and to expand multiyear procurement for major weapons systems.

And stability begins with a commitment to maintain a steady, moderate, and affordable increase in defense spending -- an increase we must have in order to maintain and continue to modernize our forces. Following the freeze for 1990, that means growth -- one percent -- '91, '92, rising to two in '93 -- two percent. For too long, defense spending has ridden a roller coaster -- unpredictable ups and downs, a recipe for waste and inefficiencies. Stable spending makes it possible to plan for the long-term -- and that's the basis of a more efficient and effective defense posture.

And that long-term view is the one we must take, with the 21st century only 11 years away.

I'm convinced that in the years ahead the United States can take the lead in building a more peaceful international environment -- in laying the foundations for a new American Century, where freedom and democracy will flourish.

I am confident that Dick Cheney will play a pivotal part in keeping America strong and secure, free and at peace.

Secretary Cheney, congratulations. You have my complete confidence and my sincere best wishes as you undertake this extraordinarily important task for the greatest country on the face of the Earth. (Applause.)

(The oath is administered.)

SECRETARY CHENEY: Mr. President, distinguished guests, men and women of America's Armed Forces, ladies and gentlemen. It is a humbling experience to assume office as the nation's 17th Secretary of Defense. Mr. President, I thank you for the confidence you've placed in me. I will do my best to justify your trust.

This transition comes at a time of significant change -- change that may portend a more peaceful and prosperous world in years ahead. Nations whose political and economic systems, like ours, are based on principles of freedom, democracy, individual liberty, and market economics are thriving. Those nations that derive their legitimacy from the authoritarian suppression of the human spirit are in retreat.

It's become clear in the last few years that freedom works. The Soviet Union is being forced to question its basic assumptions in light of its obvious failure to produce a prosperous economy at home or to enable it to compete abroad. Developing nations no longer look to the Soviets or their allies for a model upon which they can build successful economies.

And in place of a hostile Soviet Union seeking to expand its empire by military means, we see an empire beset by difficulties withdrawing from Afghanistan and talking about significant troop reductions in Eastern Europe.

In part, this change is attributable to more realistic leadership inside the Soviet Union. But it is also due in part to the success of the strategy of the United States and our allies. Containment has worked. Deterrence is held. Principle has paid off. Still, dangers abound. There are those who want to declare the Cold War ended. They perceive a significantly lessened threat, and want to believe that we can reduce our level of vigilance accordingly.

But I believe caution is in order. However real the reform rhetoric coming out of the Kremlin, Moscow's armaments compel caution on our part. To date, there's been no reduction in the strategic systems targeted against the United States. Until we see a significantly lessened military capability on the part of the Soviets, we cannot possibly justify major reductions in our own. We must guard against gambling our nation's security on what may be a temporary aberration in the behavior of our foremost adversary.

Mr. President, the military and civilian professionals of the Department of Defense stand ready to do everything possible to provide for the nation's security with the resources the American people entrust to us. To that end, our strategy and policies must be carefully calibrated to an ever-changing international landscape. Our force is designed and equipped to meet the full range of likely contingencies, and our needed munitions acquired as efficiently as possible.

Today I would like to address myself to several key groups. To the men and women of America's Armed Forces, I am honored to serve with you in the defense of freedom. Every individual soldier, sailor, airman, and Marine contributes to America's strength, and I pledge to do my utmost to provide you the quality, equipment, and support you must have to do the job we ask you to do for all of us. You, our uniformed men and women, are my number one priority. You and your families are the mind, body, and soul of America's military might.

To America's friends and allies around the world, I look forward to working with you in our common quest. Collective security is the only strategy for our democracies. We, therefore, must deepen our cooperation, especially to stretch scarce defense resources. And where we have differences, we must deal with them in recognition that cohesion is the most potent power and weapon of free nations.

To the United States Congress, fresh as I am from your ranks, I appreciate your constitutional responsibility for America's defense. I pledge my full cooperation as, together, we wrestle with a shared challenge -- too many claims on too few dollars. I've got to make the hard choices, and I seek your support so that these can be the right choices.

To America's defense industry, U.S. national security is vitally dependent on our defense industrial base. We must have top-notch firms willing to compete for defense contracts and able to fulfill those contracts with high quality work efficiently delivered. Don Atwood and the rest of my staff are anxious to work with the defense industry to improve productivity, reduce costs, and advance new technologies. Defense acquisition is a partnership, and that spirit must guide our actions.

Finally, to the American people. The first obligation of

the federal government is the defense of the nation. You support that aim with your tax dollars and the sacrifices of your sons and daughters in uniform. We who are appointed to lead these defense preparations owe you, the American people, a high return on your investment and great care for the lives of your loved ones who serve. I accept that responsibility. And with the support of my family, and the President of the United States, and with many other dedicated Americans sharing the solemn stewardship, I am ready and eager to serve. (Applause.)

END

2:35 P.M. EST

The Thomas A. Roe Institute for Economic Policy Studies

May 2, 1989

**CAPITAL GAINS TAXATION:
THE EVIDENCE CALLS FOR A REDUCTION IN RATES**

By Ronald Utt
John M. Olin Fellow

INTRODUCTION

How to tax capital gains remains one of the most controversial issues confronting economic policy makers. Though a number of countries, like the Republic of Korea, do not tax capital gains at all, the United States approach has been a roller coaster. In the mid-1970s, for example, capital gains were taxed as high as 35 percent; this top rate was cut to 28 percent in 1978 and cut further to 20 percent by the 1981 Reagan tax reduction. Then the pendulum swung abruptly, and surprisingly, back in the comprehensive overhaul of the tax code in 1986. As a result, capital gains today are taxed at the same rate as ordinary income. This rightly alarms many economists because a high capital gains tax discourages investment, savings, and entrepreneurial risk-taking. Without these, the U.S. will become economically less competitive in the world.

Bipartisan Support. The Bush Administration, too, is alarmed by the economic disincentives spurred by today's high tax on capital gains. To remedy this, George Bush is proposing to reduce the maximum tax on certain capital gains from the current 33 percent to 15 percent. This call for a lower rate on capital gains is echoed in Congress, where nearly a dozen capital gains rate reduction bills have been introduced by Republicans and Democrats. These proposals have bipartisan support. Yet the prospect of capital gains rate reductions has generated intense opposition from a variety of sources — notably organized labor.

Opponents of capital gains rate reductions attempt to build their case on three arguments:

1) **Equity and Fairness** – Capital gains preferences, critics say, favor the wealthy by providing a disproportionate share of the benefits to upper income taxpayers.

2) **Cost** – A capital gains tax rate reduction is said to increase the federal deficit because it will reduce tax revenues.

3) **Effectiveness** – A lower capital gains rate, critics argue, will have little effect on the decisions of individuals to invest or engage in entrepreneurial activity.

Each of these criticisms is challenged by supporters of capital gains tax reductions. They marshal an extensive collection of facts and research to demonstrate that the opponents' positions either are exaggerated or simply untrue. In particular, the two capital gains tax rate increases and the two tax decreases since 1969 provide solid evidence how individuals, businesses, and markets respond to such changes. What the last two decades reveal is that investors, businesses and venture capital markets are sensitive to changes in the capital gains tax rate. The data show that when rates are raised, venture funding slows or declines; conversely, when rates are cut, the venture capital market spurts.

Many opponents of the tax cut will concede that the cut will create economically useful incentives, but they worry about the ostensible loss of tax revenues. Studies reveal, however, that these concerns are unwarranted. Detailed econometric studies of the record since World War II indicate that capital gains tax rate cuts actually generate tax revenues by encouraging individuals to invest in taxable assets, unlock realized and taxable gains and redeploy capital efficiently – generating taxable income.

Evenly Spread Gains. The evidence also indicates that the fairness concerns are misplaced. When income is properly measured, the data reveal that capital gains realizations are spread rather evenly throughout different income levels and do not accrue only to the rich. Indeed, households earning less than \$20,000 accounted for more than a quarter of all capital gains reported by taxpayers in 1985.

Lawmakers considering legislation to reduce taxes on capital gains should examine this evidence carefully. Critics of tax cut proposals will level charges that a cut would be bad for the economy and the budget, and unfair to moderate and low-income taxpayers. Yet the data refute them, suggesting strongly that a cut would boost the economy while spreading tax benefits to all major income groups.

WHY TAXING CAPITAL TROUBLES MANY ECONOMISTS

The debate over the wisdom of cutting taxes on capital gains begins with the very idea of whether the realized appreciation of any capital asset should

be taxed. Many economists contend that such gains should not be taxed at all because they reflect either inflation or the market's assessment that a company's (or asset's) future earnings will be higher.

Inflation Penalty. If the gain is in part due to inflation, then a capital gains tax serves to confiscate existing wealth accumulated from past income that already has been taxed at least once. Moreover, the tax, or penalty for inflation, is imposed only when the asset is converted from one form to another, thereby discouraging capital mobility and the efficient allocation of scarce resources.

This inflation penalty is not trivial. Under circumstances similar to those occurring in the 1970s and early 1980s, it could lead to very high implicit tax rates. For example, under current law, an investment providing a real return of 5 percent in an economy with 8 percent inflation would be subject to an effective tax rate of 57.5 percent on real earnings if sold after five years.¹ Economic columnist Warren Brookes noted that a 1970 investment in stock that was sold in 1988 would pay an effective tax rate of 339 percent on the net real gain because the rate of inflation over the period was almost as great as the appreciation in the stock market.²

Triple Taxation. When the gains reflect the market's reevaluation of the company's future profit potential, then the taxation of such gains, when realized, constitutes the triple taxation of income from capital: first when it is earned by the corporation and paid in corporate income tax; next when paid out as dividends and taxed at the shareholder's personal rate; and a third time when the gains are realized through the sale of the shares.

The tax code in the past has attempted to compensate for market reevaluation by providing special treatment for capital gains. For example: residential housing, which represents the single biggest investment for most households, is largely free of capital gains tax as long as the proceeds from the sale are reinvested in another residence, or if they represent a one time cashing out of the investment close to retirement. Similarly, professional investors in income-producing real estate are able to avoid capital gains taxes through a technique known as a "tax free exchange of property."³ Investments in financial assets, however, have never been permitted this privilege, although the capital gains exclusion, which was an integral part of the tax code until 1987, reflected an inadequate attempt to do so.

Absent appropriate tax exclusions, the gauntlet of taxation faced by investors discriminates against capital income, discourages savings and investment, and harms U.S. international competitiveness by raising the cost of capital for Americans relative to that of foreign competitors, many of

1 James M. Poterba, "Venture Capital and Capital Gains Taxation," National Bureau of Economic Research *Working Paper* No. 2832, January 1989, p. 17.

2 Warren Brookes, "Fairness, Envy and Capital Gains," *The Washington Times*, March 14, 1989.

3 This process allows certain investors to postpone the taxation of capital gains in real estate by immediately reinvesting the proceeds of the sale in another income-producing property.

whom fully exempt capital gains from income taxes. In fact, Belgium, Italy, Japan, The Netherlands, Hong Kong, Malaysia, Singapore, South Korea and Taiwan exempt all capital gains from income taxation, while long-term (six months) capital gains in Germany are exempt. Meanwhile, effective capital tax rates in the U.S. have been increasing. The January 1989 *Economic Report of the President* calculates that the effective tax rates on investment in equipment due to the Tax Reform Act of 1986 quadrupled from 10 percent to 39.6 percent.

THE IMPACT OF CAPITAL TAXATION ON INVESTMENT DECISIONS

Advocates of a reduced tax rate or an exclusion for capital gains contend that these changes would increase savings and investment by decreasing the cost of capital to a firm and increasing the return on investment to the investor. At present, the gauntlet of corporate income taxes, the taxation of capital gains, and personal income taxes creates a large gap between what business earns on an investment and what the individual shareholders ultimately receive. This gap often is referred to as the "tax wedge." Reduced tax rates would encourage individuals to acquire a financial asset by raising the after tax rate of return on the asset. Such rate reductions would make investments in new and growing firms relatively attractive because most benefits of such investments would be in the form of capital appreciation rather than income paid in taxable dividends.

For the firm, a lower capital gains rate would reduce the effective cost of capital and encourage the acquisition of productive assets. For the new and growing firm, with limited income but unlimited promise, a lower rate or capital gains exclusion would encourage investors to take risks by offering the opportunity for a potentially higher reward.

What the Data Reveal

Several studies and surveys on the affect of capital gains rates on the willingness of investors to acquire shares in new firms support the view that rate reductions have stimulated venture capital market growth. Although some analysts challenge this, arguing that a substantial portion of venture funding comes from non-taxed sources such as pension funds, the surveys and studies do not support this and instead indicate that the individual investor is an important participant in the venture capital market.

In a 1988 study by economists John Freear of the University of New Hampshire and William Wetzel of Babson College, questionnaires were sent to the chief executive officers of 1,073 technology-based ventures founded in

New England between 1975 and 1986.⁴ The results from the 284 firms responding indicate:

1) **More new technology-based firms raise equity-type capital from private individuals than from any other outside source, including venture capital firms.**⁵

2) **Private individuals are the primary source of outside equity-type capital for new technology-based firms when total funds raised each time the firm goes to the financial market is under \$1 million.**

3) **Private individuals tend to invest earlier in the life of a new technology-based firm than do other outside sources of equity type capital, including venture-type⁶ funds.**⁷

Significantly, an analysis of the ebb and flow of venture capital over time indicates that there is a close correlation between the availability of such funds and changes in the capital gains tax rate. Table 1, which presents the trend in Initial Public Offerings (IPOs) as one measure of venture capital raised in organized securities markets, illustrates the sensitivity of new offerings by firms going public to the capital gains tax rate.⁸

Soaring Capital. As the table indicates, when rates increased between 1969 and 1978, initial public offerings declined significantly, from an annual average of nearly \$2 billion between 1969 and 1972 to an average of just \$225 million between 1975 and 1978. But following the major rate reductions in 1979 and again in 1982, the capital raised through IPOs soared, stalling at a plateau beginning in 1986-1987 when the rate was raised from 20 percent to 28 percent under the 1986 Tax Reform Act. Since then the amount raised has declined slightly and likely will continue this trend through 1989.

Table 2 illustrates the same connection between capital formation and capital gains tax rates using figures from the venture capital market⁹. As in the case of IPOs, the venture capital market has expanded when capital gains tax rates are cut, and has declined or stagnated when rates are increased.

4 John Freear and William E. Wetzel, "Equity Financing for New Technology-Based Firms," paper prepared for the Babson Entrepreneurship Research Conference, Calgary, Alberta, May 1988.

5 Equity-type investments are those that provide a share of the ownership to the investor and a right to participate in the profits.

6 "Venture-type" funds are professional investment companies that specialize in investing in promising new companies.

7 The authors' hypothesis that total equity type capital raised by these firms from private individuals exceeds the total capital raised from other outside sources, including venture capital funds, was not validated by the study. Indeed, the study found that the firms in the sample raised five times more capital from the funds than they did from individuals. Although many of these funds are tax-exempt, many of their investors are not, and the profits and gains of these funds are passed on to the investors who are taxed as individuals or corporations according to whether the earnings were ordinary income or capital gain.

8 IPOs refer to new capital issued through initial public stock offerings of corporation. This capital flows largely to relatively young rapidly growing companies.

9 Venture capital here refers to funds raised by companies that specialize in investing in the shares of new businesses.

Opponents of capital gains tax relief argue that such correlations merely are coincidence, not causation. They contend that the growth in the venture capital market really reflects the development and commercialization of new technologies, or the general improvement in equity markets that occurred during the same period.

Table 1
New Capital Raised Through Initial Public Stock Offerings (IPOs)

Year	Capital Gains Tax Rate	Number of IPOs	Dollars Raised (billions)
1969	27.50%	1,026	\$2.61
1970	28.91	358	0.78
1971	29.82	391	1.66
1972	30.50	568	2.72
1973	30.91	100	0.33
1974	31.55	15	0.05
1975	31.81	15	0.27
1976	33.49	34	0.23
1977	33.77	40	0.15
1978	34.13	45	0.25
1979	25.97	81	0.51
1980	26.67	237	1.40
1981	24.81	448	3.22
1982	20.00	222	1.45
1983	20.00	884	12.62
1984	20.00	354	3.9
1985	20.00	362	8.6
1986	20.00	719	22.4
1987	28.00	541	24.2
1988	28.00	280	23.4

Source: *Going Public: The IPO Reporter* (Philadelphia, Pennsylvania) and the U.S. Treasury.

Yet such alternative explanations of the correlation are not, of course, necessarily independent of capital gains tax rates, because changes in the capital gains tax rates have a direct influence on these other factors by improving the incentives in the market and encouraging individuals to invest in shares. Lower capital gains tax rates increase the incentive to invest, and this increased demand for assets raises the price of financial assets, such as common stocks. Similarly, when investor interest is increased in securities offering capital gains potential, new and growing firms capable of providing such potential will be encouraged to bring their shares to market. Comparative observations by M.I.T. economist James Poterba in his recent

study for the National Bureau of Economic Research offer some support for this view. According to Poterba:

In the decade between 1976 and 1986, the stock of commitments to the U.S. venture capital industry rose at a compound annual rate of 17.1%. Measured in constant dollars, the pool of venture capital funds in 1986 was 4.85 times as large as the pool one decade earlier. In Canada, by comparison, the annual growth rate of venture funds was only 5.7%, so that in 1986 the pool of funds was 1.75 times as large as in 1976. While international comparisons are difficult because of problems in controlling for institutional differences, the finding that venture capital investment grew more rapidly in the United States, the country that reduced its capital gains tax rate, is further supporting evidence for a potential link between capital gains taxation and venture capital.¹⁰

Elsewhere in his study, Poterba presents additional information to underscore this relationship.

Since the Tax Reform Act of 1986, which raised individual capital gains tax rates from 20% to 28% (or in some cases 33%) venture funding has been stable. Total revenue commitments increased six percent between 1986 and 1987, and preliminary 1988 data suggest that this level has at least been maintained through 1988. The recent growth of venture capital investment in other nations, however, suggests that the post-1986 U.S. performance may reflect a negative effect of tax reform. In the U.K., the flow of venture capital commitments nearly doubled between 1986 and 1987. In Canada, venture funding rose even more dramatically, from \$209 to \$800 million. While the growth of venture capital in Canada and Britain may in part reflect the maturation of their venture capital industries, they provide a useful contrast to the recent U.S. experience.¹¹

THE IMPACT OF CAPITAL GAINS TAXES ON TAX REVENUES

Although the evidence strongly indicates that lower capital gains rates encourage individuals to fund risky ventures, many policy makers still question whether the benefits are worth the potential losses in tax revenues due to a lower tax rate on capital gains. Skeptics also believe that a lower rate of taxation bestows disproportionately greater benefits on higher income individuals than on moderate income Americans.

¹⁰ Poterba, *op. cit.*, pp. 4-5.

¹¹ *Ibid.*, pp. 2-4.

Table 2
Supply of Venture Capital Financing, 1969-1987

Year	Net New Commitments to Venture Capital Firms (billions)	Maximum Personal Tax Rate on Capital Gains (percent)
1969	\$ 505.7	27.50
1970	271.8	28.91
1971	251.8	29.82
1972	156.9	30.50
1973	133.2	30.91
1974	124.2	31.55
1975	19.8	31.81
1976	93.3	33.49
1977	68.2	33.77
1978	978.1	34.13
1979	449.2	25.97
1980	961.4	26.67
1981	1,627.8	24.81
1982	2,118.6	20.0
1983	5,097.7	20.0
1984	4,590.0	20.0
1985	3,502.3	20.0
1986	4,650.1	20.0
1987	4,900.0	28.0
1988	---	28.0

Source: Column 1, Venture Economics, *Venture Capital Yearbook 1988*, p. 17. Entries as presented in 1987 dollars, deflated using the GNP deflator. Column 2, U.S. Treasury.

Proponents of a lower capital gains rate counter that, contrary to the intuitively plausible proposition that rate cuts reduce revenues, experience demonstrates just the opposite: every instance of a capital gains rate cut has been followed immediately by a significant increase in capital gains realizations (net capital gains proceeds received from the sale of assets and reported to the Internal Revenue Service) and by higher taxes paid on those gains. By lowering the tax cost of selling assets, and thereby increasing the after-tax yield on such assets relative to other sources, lower capital gains tax rates can lead to greater capital gains realizations and increased total tax payments by the owners of those assets.

Stimulating Investment. Lower capital gains rates, experience shows, also increase the attractiveness of such assets relative to other sources of income or consumption. This encourages more purchases of such assets, which bids up their prices, leading to higher realizations of capital gain when the assets are sold — both because there are more investors now holding such assets and because the increased demand raises their price and profits. Again, this rise

in value and volume can mean higher tax payments even at a lower tax rate. And to the extent that such tax rate reductions stimulate more investment, business formations and entrepreneurial activity, then general income tax revenues also would rise.

What the Data Reveal

As Table 3 indicates, the rate cuts of both 1979 and 1982 were followed by large increases in reported capital gains and by increases in capital gains tax payments. Conversely, the tax rate increase enacted in 1969 was followed by declining realizations and lower capital gains tax revenues. Indeed, the \$5.9 billion of capital gains revenues received in 1968 was not exceeded until 1976.

Some opponents of a cut in capital gains tax do admit that a rate reduction does boost immediate tax yields, but then they argue that the observed increase merely reflects a change in the timing of realizations that would ultimately occur at higher tax rates. Today's tax gains from a cut, they contend, simply would be at the expense of higher tax payments in the future under current rates.

Complex, Arcane Research. The primary focus of the debate over the capital gains tax is the predicted effect on tax revenues. As the debate has become more intense, the economic research on the subject has become more extensive and systematic, but unfortunately also more complex and arcane. Nonetheless, a review of the most recent studies suggests that the weight of evidence is shifting in favor of those analysts who argue that revenues will not decline if rates are cut.

A 1987 review of the academic literature by Harvard economist Lawrence B. Lindsey concludes that it is extremely unlikely that the capital gains tax increase in the Tax Reform Act of 1986 will produce any additional tax revenue.¹² Most likely, he says, it will produce less revenue than the much lower tax rates of the old law.

Seeking the Best Rate. According to Lindsey, all but one of the academic studies he reviewed predict 1987-1991 revenue losses in the range of \$27 to \$105 billion when compared with what would have occurred under prior law. Lindsey notes that these same academic studies imply that the capital gains tax rate that would yield the most revenue lies in the range of 9 percent to 21 percent. This finding has led most of the sponsors of a rate cut to settle on a 15 percent rate.

¹² Lawrence B. Lindsey, *Capital Gains Taxes Under the Tax Reform Act of 1986: Revenue Estimates Under Various Assumptions* (Cambridge, Mass.: National Bureau of Economic Research, 1987).

Table 3
Capital Gains Realizations and Tax Revenues
1954-1985

Year	Capital Gains Realizations (billions of \$)	Tax Revenue (billions of \$)	Marginal Tax Rate (percent)
1954	7.157	1.010	25.00
1955	9.881	1.465	25.00
1956	9.683	1.402	25.00
1957	8.110	1.115	25.00
1958	9.440	1.309	25.00
1959	13.137	1.920	25.00
1960	11.747	1.687	25.00
1961	16.001	2.481	25.00
1962	13.451	1.954	25.00
1963	14.579	2.143	25.00
1964	17.431	2.482	25.00
1965	21.484	3.003	25.00
1966	21.348	2.905	25.00
1967	27.535	4.112	25.00
1968	35.607	5.943	26.87
1969	31.439	5.275	27.50
1970	20.848	3.161	28.91
1971	28.341	4.350	29.82
1972	35.869	5.708	30.50
1973	35.757	5.366	30.91
1974	30.217	4.253	31.55
1975	30.903	4.534	31.81
1976	39.492	6.621	33.49
1977	45.337	8.104	33.77
1978	50.526	9.104	34.13
1979	73.443	11.669	25.97
1980	74.582	12.459	26.67
1981	80.938	12.684	24.81
1982	90.153	12.900	20.00
1983	119.118	18.468	20.00
1984	138.658	21.534	20.00
1985	168.570	24.495	20.00

Source: U.S. Treasury.

A 1988 study by the Congressional Budget Office (CBO) disputes this reasoning, however.¹³ Although the study found changes in tax rates on capital gains produce a significant change in the behavior of investors, it would not be sufficient to generate higher revenues from lowering the tax rate on capital gains to 15 percent. But the authors of the study note the crucial caveat that their statistical estimates are sufficiently imprecise that a conclusion that lower rates will raise revenues cannot be ruled out.

The revenue impact debate currently centers on an updated study recently completed by the U.S. Treasury.¹⁴ The original Treasury study, completed in 1985, concluded that:

The available statistical evidence shows that the reduction in tax rates on capital gains in the 1978 Act caused a substantial increase in revenue from capital gains taxes in the first year after the tax cut, and in the long run either increased or only slightly decreased the annual Federal revenue from capital gains taxes.¹⁵

Source of Debate. The 1985 study came essentially to the same conclusion regarding the 1981 capital gains tax rate cuts, but the reluctance of tax critics to accept the broad conclusions of the 1985 study led the Treasury to update its findings. The 1988 report concludes:

When we extend the original Treasury specifications through 1985, the results imply that the 1978 act produced large and continuing direct revenue gains. Extension of the sample and correction of the flaw in the Treasury report's measurement of inflationary GNP dramatically reduce the estimated losses from the 1981 changes. Finally, substitution of clearly superior regression specifications taken from the 1988 CBO study yields the conclusion that both acts were significantly revenue enhancing.¹⁶

These results immediately were challenged by the opponents, and that challenge was met just as quickly by the authors.¹⁷ As Joseph Minarik, a critic of the Treasury studies, observes in his most recent critique, "The battle over capital gains taxation will probably last as long as we own our income tax."¹⁸ And so the battle continues, but with the weight of evidence growing in favor

13 "How Capital Gains Rates Affect Revenues: The Historical Evidence." The Congressional Budget Office, March 1988.

14 Michael R. Darby, Robert Gillingham, and John S. Greenlees, "The Direct Revenue Effects of Capital Gains Taxation: A Reconsideration of the Time Series Evidence," U.S. Treasury, Research Paper No. 8801, May 1988.

15 "Report to Congress on the Capital Gains Tax Rate Reductions of 1978", U.S. Treasury Dept., September 1985.

16 Darby, *et al.*, *op. cit.*, pp. 2-3.

17 Joseph Minarik, "The New Treasury Capital Gains Study: What is in the Black Box?" *Tax Notes*, June 20, 1988; and Michael R. Darby, Robert Gillingham, and John S. Greenlees, "The Black Box Revealed: Reply to Minarik," *Tax Notes*, July 25, 1988.

18 Minarik, *op. cit.*, p. 1471.

of the proposition that a capital gains tax rate cut will not lose revenue, and may even gain some.

TAX REVENUES AND FAIRNESS: WHO WINS?

Closely related to the issue of revenues is that of fairness — who would receive the benefit of a rate reduction and how would this change their tax obligations. Few myths are as enduring as the belief that reductions in the capital gains tax rate shift the tax burden from the rich to the poor. Opponents of capital gains rate cuts assert that the rich would receive a disproportionate share of the capital gains realizations and most of the benefits. By their definitions, the critics note that the wealthiest two percent of the population receive more than a quarter of their annual income in the form of capital gains and that nearly 75 percent of all capital gains realizations are received by taxpayers with incomes over \$100,000, while 45 percent of such gains go to those with incomes in excess of \$500,000. One such critic notes that Bush's proposal would "save" the richest taxpayers at least \$25,000 a year but save only \$20 for most of those earning \$60,000 or less.¹⁹

Supporters of the rate cut respond that such tax rate reductions actually would increase tax payments from the wealthy because it would induce them to shift their wealth from tax shelters to taxable investments and to "unlock" gains that were not realized because of high taxes. The evidence supports this view. Past rate cuts have led to substantial increases in capital gains realizations and tax payments, and that an increased share of these tax payments comes from upper-bracket taxpayers. Table 4 demonstrates this.

Table 4

Adjusted Gross Income	Taxes Paid on Capital Gains (\$ thousands)		Percentage Increase 1980-1984
	1980	1984	
\$0-20,000	422,097	574,917	36
20,000-75,000	1,847,440	2,543,912	37
75,000-200,000	1,915,221	3,478,397	82
200,000-500,000	1,443,513	3,405,787	136
500,000+	2,363,446	9,598,114	306

Source: Estimated by the Office of Tax Policy, U.S. Chamber of Commerce using Statistics of Income, Internal Revenue Service

As the table indicates, the tax payments by the richest segment increased more than eight times that of the lowest income group. Critics may contend that the rise in revenues merely reflects the improving stock market over the period, and that the largest single source of capital gains realizations are from the sales of common stock. But such a contention simply is not supported by

¹⁹ Robert S. McIntyre, Statement before the Senate Finance Committee, March 14, 1989.

the facts. Over the period covered in the table, the New York Stock Exchange Composite Index rose by just 36 percent compared with the 306 percent increase in tax payments by the richest income group. Revenue increases of this magnitude reflect increased unlocking of gains, proportionately more investment in taxable assets, and greater mobility of capital.

Table 4 also demonstrates that the cut in taxes actually shifted the tax burden toward the richest groups, in contrast to the popular wisdom. Between 1980 and 1984, the share of capital gains taxes paid by taxpayers earning \$20,000 or less declined from 5.3 percent to 2.9 percent, while the share from taxpayers reporting incomes of \$500,000 or more rose from 29.6 to 48.6 percent of all taxes paid on capital gains.

While Table 4 and analysis demonstrate the extent to which capital gains rate reductions lead to proportionately greater tax payments by the higher income households, such aggregate data as presented in Table 4, actually overstate the extent to which capital gains realizations are experienced by the wealthier households. In fact, capital gains realizations tend to be spread rather evenly throughout the income distribution when the income distribution is defined to include only "recurring" income — that is, reported income less capital gains realizations.

Important Distinction. This distinction in the measurement of income is important. For many individuals, capital gains realizations are infrequent occurrences and reflect a unique one-time event that makes the taxpayer appear rich by pushing him into the higher income brackets. Realized capital gains tend often to be such non-recurring events as: the sale of a small business upon retirement; an elderly widow liquidating her husband's accumulated investments; the sale of stock to buy a house or pay for a child's college tuition; or the liquidation of an investment portfolio in anticipation of an economic downturn. When aggregated with other income, these give the appearance of being received almost exclusively by the very rich.

Table 5 shows the relationship of capital gains realizations to levels of income net of capital gains. With this correction, it can be seen that realized capital gains actually are distributed rather evenly throughout the income distribution. More than a quarter of realizations were experienced by households earning \$20,000 or less, and households earning less than \$75,000 received more than half of realized capital gains. Thus, in stark contrast to the claims of the critics, a capital gains rate reduction would provide significant benefits to all income levels, not just to the affluent.

THE PROPOSALS BEFORE CONGRESS

Nearly a dozen proposals to reduce the rate have been introduced in this Congress. The proposals differ widely in coverage, holding period, rate reduction, complexity and economic impact. To evaluate rival measures, lawmakers need to judge them against a set of base criteria. Among the most important of these:

1) Tax Rates

Since a key goal of a tax cut must be to stimulate the greatest volume of investment with the minimum revenue loss to the Treasury, preference should be given to those proposals that cut the tax rate as deeply as possible while still leaving it within Professor Lindsey's estimated revenue maximizing range of 9 to 21 percent. With 15 percent as the mid-point of this range, proposals which include rate cuts to 15 percent or less should be preferred. Bush's proposal, with rates ranging between 0 and 15 percent, and H.R. 461 and H.R. 499, with flat rates of 15 percent, lead the list. S. 171 with its implied top rate of 16.5 percent is close to this group of leading measures.

Table 5
Distribution of Capital Gains by Recurring Income: 1985

Income Group (thousands of \$)	Capital Gains (billions of \$)	Percent of All Gains
Under \$10	\$35.30	20.79
10-20	8.90	5.24
20-30	10.70	6.30
30-40	10.10	5.95
40-50	11.10	6.54
50-75	17.50	10.31
75-100	12.50	7.36
100-150	13.10	7.71
150-200	8.70	5.12
Over 200	41.90	24.68
Total	169.80	100.00

Source: Internal Revenue Service, 1985 Individual Tax Model File, Public Use Sample.

2) Holding Period

In principle there should be no required holding period before an asset becomes eligible for taxation as a capital gain instead of as ordinary income. Required holding periods serve no useful economic purpose and probably distort investment patterns in a counterproductive direction. In practice, however, the tax code has made a distinction between short-term and long-term capital gains, with the preferential rates being applied to the latter as a disincentive to speculation. Qualifying periods have varied from a low of three months to as long as a year. Currently the qualifying period is six months.

Alleged Failing. A popular, though unverified, notion holds that many of America's competitive problems stem from the "shortsightedness" of its business managers. The lengthy holding periods in several of the proposals represent a peculiar, though ineffective, way of curing this alleged failing. In fact, few other industrialized countries, including the "far-sighted" Japanese, make such a distinction.

The many capital gains proposals now under consideration contain required holding periods ranging from none in H.R. 461, one year for H.R. 499 and S.171, and four years for S.348. Inasmuch as all of these proposals seek to encourage entrepreneurial start-ups, the lengthy holding period could discourage such investments. Even a one-year required holding period might be too long. With the average postwar business cycle averaging five years, the four and five year holding periods required by several of the proposals could shift needed investment away from new firms in favor of mature companies.

3) Coverage

In an effort to target the tax incentive to preferred forms of economic activity, each of the legislative proposals would limit the preference to certain types of investments. For instance, S.171 covers only common stock, S.348 covers newly issued common stock in firms with less than \$100 million paid in capital, while the Bush plan covers all common stocks as well as bonds, land and non-depreciable real property. S.551, H.R. 461 and H.R. 499 are the most inclusive in coverage, with the latter two proposals including virtually all assets. Excluded from many plans are "collectibles" and depreciable real estate such as office building and apartment complexes. Owner-occupied housing also is excluded, but existing preferences in the tax code serve effectively to shelter realized capital gains on houses.

As with the holding period, the exclusion of certain types of assets distorts investment decisions and leads to an inefficient allocation of capital resources. Bonds are held by investors for their potential capital gain as well as interest income. Precluding them from capital gains taxation could raise bond interest rates relative to the return on equities and penalize those firms dependent upon debt for capital. This interest rate burden would fall more heavily upon the mature and troubled industries with limited access to equity markets. It also could lead to immediate wealth losses for individuals and institutions (such as pension funds) with bonds in their portfolios.

Favoring New Ventures. S. 348 would extend the capital gains tax preference only to the newly issued shares of businesses with paid in capital of less than \$100 million, to target assistance to new and growing small businesses. But although new ventures play a vital role in a dynamic economy, there is no particularly good economic reason to assist them at the expense of their larger competitors. Such discrimination could lead to serious distortions, misallocating capital throughout the economy and encouraging costly and unproductive corporate restructurings to take advantage of the tax rate reduction on special classes of shares.

Proposals such as S. 348 also would create complexities among new and existing shareholders of eligible companies and these complexities and uncertainties could offset in whole or in part the benefits of the more favorable capital gains treatment. Growing companies generally issue their shares in increments over their first several years of existence as the need for capital arises and as they become better established in the market. Because newly issued shares would under S. 348 be sold with the one time capital gains tax preference, existing shares — which now would sell without the

preference — would decline in value in secondary trading whenever a new offering is announced. This added uncertainty, combined with the required four year holding period and relatively high capital gains tax rate, suggest that S. 348 would provide very limited incentives to investors, and thus would do little to assist new firms in raising capital.

CONCLUSION

The evidence accumulated since World War II makes a powerful case in favor of a substantial reduction in the capital gains tax rate. Whether the issue is encouraging savings and investment, fairness, or revenues, the data and the studies demonstrate that concerns expressed by critics of a cut are either unwarranted or exaggerated.

Increasing Economic Well-Being. In response to this evidence, the White House and many members of Congress from both political parties have developed proposals and introduced legislation to rectify the mistakes made in the treatment of capital gains by the Tax Reform Act of 1986. While some of these proposals are better than others, collectively they represent a growing appreciation by public officials that low tax rates make important contributions to America's economic well-being. This trend should be encouraged and Congress and the White House should work together to craft legislation to apply a lower tax rate to a broad definition of financial and tangible assets.

All Heritage Foundation papers are now available electronically to subscribers of the "NEXIS" on-line data retrieval service. The Heritage Foundation's Reports (HFRPTS) can be found in the OMNI, CURRNT, NWLTRS, and GVT group files of the NEXIS library and in the GOVT and OMNI group files of the GOVNEWS library.

Speechwriters
FYI

WHITE HOUSE STAFFING MEMORANDUM

DATE: 03/24/89 ACTION/CONCURRENCE/COMMENT DUE BY: ----

SUBJECT: FRIDAY ECONOMIC AND FINANCIAL REPORT (prepared by OMB)

	ACTION FYI			ACTION FYI	
VICE PRESIDENT	<input type="checkbox"/>	<input checked="" type="checkbox"/>	MCCLURE	<input type="checkbox"/>	<input checked="" type="checkbox"/>
SUNUNU	<input type="checkbox"/>	<input checked="" type="checkbox"/>	NEWMAN	<input type="checkbox"/>	<input type="checkbox"/>
SCOWCROFT	<input type="checkbox"/>	<input type="checkbox"/>	PORTER	<input type="checkbox"/>	<input checked="" type="checkbox"/>
DARMAN	<input type="checkbox"/>	<input type="checkbox"/>	STUDDERT	<input type="checkbox"/>	<input type="checkbox"/>
BATES	<input type="checkbox"/>	<input checked="" type="checkbox"/>	UNTERMAYER	<input type="checkbox"/>	<input type="checkbox"/>
BREEDEN	<input type="checkbox"/>	<input checked="" type="checkbox"/>	BOSKIN	<input type="checkbox"/>	<input checked="" type="checkbox"/>
CARD	<input type="checkbox"/>	<input checked="" type="checkbox"/>	_____	<input type="checkbox"/>	<input type="checkbox"/>
CICCONI	<input type="checkbox"/>	<input checked="" type="checkbox"/>	_____	<input type="checkbox"/>	<input type="checkbox"/>
DEMAREST	<input type="checkbox"/>	<input checked="" type="checkbox"/>	_____	<input type="checkbox"/>	<input type="checkbox"/>
FITZWATER	<input type="checkbox"/>	<input checked="" type="checkbox"/>	_____	<input type="checkbox"/>	<input type="checkbox"/>
GRAY	<input type="checkbox"/>	<input checked="" type="checkbox"/>	_____	<input type="checkbox"/>	<input type="checkbox"/>
HAGIN	<input type="checkbox"/>	<input type="checkbox"/>	_____	<input type="checkbox"/>	<input type="checkbox"/>

REMARKS:

The attached is for your information.

RESPONSE:

James W. Cicconi
Assistant to the President
and Deputy to the Chief of Staff
Ext. 2702



EXECUTIVE OFFICE OF THE PRESIDENT
OFFICE OF MANAGEMENT AND BUDGET
WASHINGTON, D.C. 20503

Interest Rates
Q4 GNP
Housing Finance
Bean Counting

March 24, 1989

MEMORANDUM FOR THE DIRECTOR

FROM: John C. Weicher
SUBJECT: Friday Economic and Financial Report

Interest Rates Stabilize After Recent Jump

This week, interest rates stabilized and even fell slightly on long maturities. That's a welcome change from the prior week's increase of 20 basis points. February's Consumer Price Index, released this week, was a bit better than the market expected, with about a 5 percent annual rate rise overall and also excluding volatile food and energy items. Despite this good news, the underlying rate of inflation this year has averaged 5.3 percent, up about 1/2 percentage point from last year.

	Consumer Price Index (% change, annual rate)					
	December to December				Jan	Feb
	1985	1986	1987	1988	1989	
Total	3.8	1.1	4.4	4.4	7.2	5.1
Food	2.7	3.8	3.5	5.2	9.3	5.0
Energy	1.9	-19.5	8.2	0.5	9.8	6.9
Ex. Food & Energy	4.3	3.8	4.2	4.7	5.9	4.8

Fed Chairman Alan Greenspan and Vice-Chairman Manuel Johnson, in separate remarks on Wednesday, made clear that the Fed has stopped raising the federal funds rate for the time being while they wait for the effects of their previous tightening moves to appear. They stressed the long lags in monetary policy and their desire to avoid overkill and reduce the possibility of a recession. This is a clear sign that the FOMC, which meets next week, is unlikely to change policy.

The bond market bounced up a bit after the Fed officials' remarks, but the stock market headed down. In the past week, technology stocks have been hit on reports of lower earnings. IBM and Digital Equipment dropped by over 8 percent. Weakness at these major computer manufacturers is a signal of a slowdown in investment spending.

Nominal interest rates are now about 1/2 percentage point higher on long maturities and 1-1/4 percentage point higher on short maturities than projected in the budget. While this increases outlays and the deficit, the effects will be almost entirely offset by higher-than-expected inflation. Tax receipts increase proportionately to the rise in prices, while noninterest program outlays are slower to adjust in the short run. Eventually, outlays are likely to be adjusted for higher inflation, so that receipts and outlays change about equally.

Of course, higher inflation is bad news for the economy and threatens the continuation of the expansion, but it has a roughly neutral effect on the deficit in the long run. What really matters for the budget is real interest rates and real growth rates. This year's rise in nominal interest rates has been fairly closely matched by rising inflation, with little average change in real rates. Real growth was slightly higher than the Administration's projection for the fourth quarter of 1988. The budget assumes a decline in real interest rates and healthy growth over the next year and a half, a more favorable outcome than most private sector forecasts. But so far, overall economic performance is consistent with the economic projections that matter most for the budget.

Fourth Quarter GNP

Now that all the data are in for the final quarter of last year, it is clear that the economy was somewhat stronger than initially reported. The Bureau of Economic Analysis places real GNP growth at a 2.4 percent annual rate, up 0.4 percentage points from the prior reading. A change of this magnitude is not exceptional, in fact, it is equal to the average revision during the past dozen years. Excluding the drought, which cut 1.1 percentage points off the growth rate, real GNP rose at a 3.5 percent annual rate. Over the four quarter of the year, GNP also rose 3.5 percent excluding the drought's effects.

The fourth quarter inflation estimates were not revised. The GNP implicit price deflator was up at a 5.3 percent annual rate and the GNP fixed-weighted price index, which is based on a constant composition of output, was up at a 4.2 percent rate. (See attachment for details of fourth quarter GNP.)

The Administration has assumed that rising interest rates over the past year will put a damper on nonfarm growth this year, but not enough to cause unemployment to rise. The year is still young, but there are signs that this is already happening. The

sectors that were at the forefront of the expansion last year are moderating. Manufacturing production and employment slowed during the first two months of this year. In part, this reflects diminished competitiveness because of the dollar's appreciation. On the domestic front, businesses' orders for new equipment have not risen since the third quarter of last year, which will curb capital spending in the coming months. Finally, consumer spending also waned in January and February as auto sales slumped. At the same time, unemployment has actually fallen.

A slackening pace does not necessarily signal an end to the expansion. In fact, the composite index of leading indicators rose 0.7 percent in December and 0.6 percent in January, the most recent months available. That's the best back-to-back showing since last June and is consistent with the Administration's forecast for continued growth in the nonfarm economy, albeit at a slower pace than during 1988.

The Evolution of Home Finance: Part I

The problems of the Federal Savings and Loan Insurance Corporation have simultaneously focused public attention on the American housing finance system and obscured the nature of the fundamental changes that have occurred over the last decade. This story is the first in a series on the housing finance system. It describes the evolution of the system. Subsequent stories will discuss the changes in the mortgage instrument itself, in origination and servicing, and in the sources of funds for mortgages.

A Flawed Foundation

The "traditional housing finance system," dating back to the Depression, was in reality two essentially competing systems of home finance, each with Federal support: the thrift industry, and the separate system of FHA/VA insurance and secondary market development designed to attract commercial banks, life insurance companies, pension funds and other investors to mortgages.

- o Federal support for thrifts was initiated by President Hoover. The Federal Home Loan Bank System was created in 1932 to charter and regulate Federal savings and loan institutions, and to provide advances (loans) to all S&Ls. This was supplemented in 1934 by the creation of the Federal Savings and Loan Insurance Corporation to insure thrifts' deposits. The thrifts originated, serviced, and held mortgages in their own portfolios.
- o President Roosevelt started the Federal Housing Administration in 1934 to insure mortgages, hoping to encourage commercial banks and other institutions to originate and hold them. The Federal National Mortgage Association (Fannie Mae) was established in 1938 to create a secondary market for FHA insured mortgages. In the immediate postwar period, the

Veterans Administration joined the FHA as a mortgage insurer. In this system, there was a split between origination and investing: mortgage bankers typically originated and serviced mortgages, but sold them directly or through Fannie Mae to other institutions which were the ultimate investors.

The S&Ls were heavily regulated, in return for deposit insurance and preferential access to capital markets, and the regulations eventually hamstrung the system. S&Ls were required to hold most of their assets in mortgages. They were permitted to originate mortgages only within 50 miles of their home office. These holdings were financed primarily by local savings deposits. Restricting thrifts to mortgages, primarily local, ignored the wisdom of portfolio diversification. Moreover, financing portfolios of long-term, fixed-rate mortgages by short-term savings deposits exposed thrifts to interest rate risk. So long as interest rates were relatively stable, such lending was profitable. But when interest rates rose, shocked by inflation, this term mismatch led to tremendous losses.

Accelerating Inflation

As inflation ratcheted upward in the mid-1960s, the early 1970s, and again in the late 1970s, these flaws became evident. In 1966, Regulation Q, which restricted the interest rates that commercial banks could pay on deposits, was extended to S&Ls in the hope of holding down their cost of funds. Instead, it resulted in disintermediation -- a reduction in the growth of deposits available for mortgage lending. On the second ratchet in the early 1970s, money market mutual funds were created; they invested in relatively short-term, high-quality assets, and were free of the restrictions on insured depository institutions. In the third cycle, MMMFs skyrocketed from \$3.5 billion in 1977 to \$180 billion in 1981; there was a net decline in thrift deposits. The first effect of inflation was to limit and destabilize the funds thrifts had available for home finance.

The second, closely related, effect was to reduce thrifts' profits and the value of their portfolios. On a market value basis, by 1980 the industry as a whole had a negative net worth of about 12.5% of assets. Although this industry-wide figure improved as interest rates came down in the 1980s, a substantial and growing fraction of the industry was insolvent. In any other industry, they would have gone out of business. But insolvent depository institutions can only go out of business when the Federal Government closes or merges them. Instead, the FSLIC exercised forbearance. Many thrifts with little or no net worth continued in business, competing for funds, increasing the volume of originations, and seeking higher returns. Their decisions were subject to moral hazard; they might profit, but with no equity, they could lose no more.

The nature of the mortgage instrument was also affected by the continuing inflation. As rising home prices and higher interest rates reduced the affordability of homes, potential buyers sought both lower down payment requirements and easier monthly terms. On the lenders' side, high and variable inflation created a desire for variable or adjustable rate mortgages, which would shift some of the interest rate risk to the borrower.

Bundles and Packages

Another major force restructuring the mortgage market in the 1970s was the increasing power and diminishing cost of computers and telecommunications. New information technology made it possible to "unbundle" different mortgage services so that different firms could handle origination, insurance, servicing, and holding. It also made possible the securitization of mortgages. This financial innovation "packaged" the cash flows on a pool of mortgages into a variety of securities. These securities, with quite different characteristics than the underlying mortgages, were designed to appeal to a variety of investors. They were sold in the secondary market, and were more liquid than the underlying mortgages. Securitization will be discussed more fully in a forthcoming article in this series.

The establishment of the Government National Mortgage Association (Ginnie Mae) in 1968 accelerated the development of the secondary market. Ginnie Mae bought FHA and VA insured mortgages, and created pass-through securities on which it guaranteed timely payment of principal and interest. In 1970, the Federal National Mortgage Corporation (Freddie Mac) was chartered and charged with creating a secondary market in conventional (uninsured) mortgages to increase the liquidity of thrifts, and Fannie Mae was permitted to buy conventional loans as well. As a result, mortgage qualifying and underwriting standards became more uniform to facilitate sale to the secondary market.

The Culmination

By the end of the 1970s, these forces created massive pressures for changes in the housing finance system. To permit thrifts to compete for funds and smooth the flow of financing for mortgages, the Depository Institutions Deregulation and Monetary Control Act of 1980 set up a schedule for the elimination of deposit rate ceilings and the Garn-St Germain Act of 1982 authorized a deposit account similar to money market fund accounts. The DIDMCA also permitted thrifts to hold up to 20% of assets in consumer loans, commercial paper, and long-term corporate debt; Garn-St Germain permitted investment in corporate and government securities with no geographic limitation and increased the allowable limit for these non-mortgage investments to 40% by 1984. For mortgages, geographic limits on origination had been widened in several stages, and by 1983 were eliminated throughout the nation. And in 1981, thrifts were permitted to originate and hold any kind of adjustable rate mortgage.

The result of these changes is that the housing finance system of 1989 is much removed from the system of 1979, and vastly different from that of 1969. Twenty years ago, nearly all mortgages carried fixed rates for terms of 25 to 30 years; more than half were originated by S&Ls, and more than half were held by them in their own portfolios; few were sold in the secondary market; and mortgage securities were unknown. Moreover, interest rates then were much lower. Before the 1970s, S&Ls lived in a friendly environment, one that enabled them to grow and prosper. High inflation and new information technologies have changed all that: today's environment is a hostile one for S&Ls. It is no wonder that they have to struggle to survive.

Sweet Forecast Worth Hill of Beans

OMB is widely regarded as having the best bean counters in the world, and the Office of Economic Policy has the best of the best. This week, OEP's Jim Simpson won the NEOB cafeteria's jellybean counting contest. His estimate of 539 beans was closest to the actual count of 535, an error of less than 1 percent. The next closest was 619 beans. According to an informed source, most estimates were in the low thousands, which reinforces the view that OMBers believe in rosey scenarios. But not OMB's economists: Jim has provided proof positive that realism prevails in this office! "Forecasting is not an exact science", but this forecast was right on the bean, er-- beam.

HAPPY EASTER!

FOURTH QUARTER GNP

The economy grew at a revised annual rate of 2.4 percent in the fourth quarter, up 0.4 percentage points from the previous estimate. Excluding the drought, fourth quarter GNP was 1.1 percentage points higher. Inflation, as measured by both the implicit price deflator and the fixed-weighted index, remained unchanged; therefore all of the increase in nominal GNP was attributable to higher real growth.

	1988				
	Q1	Q2	Q3	Q4 Prelim.	Q4 Final
	(% change, saar)				
Real GNP	3.4	3.0	2.5	2.0	2.4
Excluding Drought	3.4	3.9	3.0	3.1	3.5
GNP Price Deflator	1.7	5.5	4.7	5.3	5.3
GNP Fixed-Weighted Price Index	3.5	5.0	5.3	4.2	4.2
Nominal GNP	5.4	8.7	7.3	7.2	7.6

The boost to fourth quarter GNP came mostly from business fixed investment, which was down less than initially measured, and from higher federal spending. Most of the higher federal nondefense revision was due to transactions of the Commodity Credit Corporation (CCC). Growth of consumption and residential investment was unchanged. The upward revisions more than offset a deterioration in the net export balance.

Business Fixed Investment	7.6	15.0	4.0	-4.6	-2.9
Personal Consumption	4.5	3.0	3.9	3.5	3.5
Residential Investment	6.5	0.2	4.3	10.9	10.9
Federal Government	-21.0	4.7	-13.2	16.8	20.7
Defense	-5.3	-1.5	-10.5	7.5	9.9
Nondefense	-60.1	33.2	-22.5	60.5	71.5
Nondefense Excluding CCC ...	-1.9	1.5	-12.9	8.0	10.9
State and Local	3.5	3.2	1.1	5.1	6.0

The real net export deficit widened, mostly due to a downward revision in exports. Imports were revised up slightly. Inventories remained essentially unchanged.

	(\$82 billions)				
Net Exports	-109.0	-92.6	-93.9	-103.3	-105.4
Exports	486.2	496.9	514.0	523.6	522.1
Imports	595.1	589.5	607.9	626.8	627.4
Inventory Change	66.0	35.3	39.5	29.3	29.1
Nonfarm	51.9	30.1	40.4	37.7	37.6
Farm	14.1	5.3	-0.8	-8.3	-8.5

Nominal and real disposable income were revised downward as a result of smaller gains in wages, proprietors' income and interest income. Corporate profits in the fourth quarter increased sharply. The quarterly pattern of profits last year was quite volatile, but overall they rose 7.5 percent.

	(% change, saar)				
Nominal Disposable Income	7.4	5.6	10.4	9.4	8.8
Real Disposable Income	5.0	0.0	5.6	4.8	4.1
Saving Rate (%)	4.4	3.7	4.2	4.5	4.3
Corporate Profits	0.1	13.7	4.4	NA	12.6

RECENT ECONOMIC INDICATORS MARCH 24, 1989
(S.A. OR AS INDICATED)

	Feb-88	Mar-88	Apr-88	May-88	Jun-88	Jul-88	Aug-88	Sep-88	Oct-88	Nov-88	Dec-88	Jan-89	Feb-89
GNP (QUARTERLY SERIES, % A.R.)													

NOMINAL GNP				8.7			7.3			7.6			
REAL GNP	5.4			3.0			2.5			2.4			
IMPLICIT PRICE DEFLATOR	1.7			5.5			4.7			5.3			
FIXED-WEIGHT PRICE INDEX	3.5			5.0			5.3			4.2			
REAL DISP. PERS. INC.	5.0			0.0			5.6			4.1			
OPERATING PROFITS	0.1			13.7			4.4			12.6			
LEADING AND COINCIDENT INDICATORS													

LEADING INDEX	140.3	140.8	141.5	141.5	143.9	142.7	144.1	143.7	143.9	143.9	144.9	145.7	MA
PERCENT	1.2	0.4	0.5	0.0	1.7	-0.8	1.0	-0.3	0.1	0.0	0.7	0.6	MA
COINCIDENT INDEX	126.5	127.3	127.3	127.6	128.5	128.9	129.3	129.3	130.6	130.7	131.6	132.9	MA
PERCENT	0.7	0.6	0.0	0.2	0.7	0.3	0.3	0.0	1.0	0.1	0.7	1.0	MA
INDUSTRIAL PRODUCTION	134.4	134.7	135.4	136.1	136.5	138.0	138.5	138.6	139.4	139.9	140.5	141.1	141.1
PERCENT	0.0	0.2	0.5	0.5	0.3	1.1	0.4	0.1	0.6	0.4	0.4	0.4	0.0
CAPACITY UTIL. MFG.	82.6	82.7	82.9	83.3	83.3	84.0	84.0	84.0	84.3	84.4	84.5	84.8	84.6
EMPLOYMENT INDICATORS													

CIVILIAN EMPLOYMENT, MIL.	114.3	114.1	114.7	114.4	115.0	115.0	115.2	115.4	115.6	115.9	116.0	116.7	116.9
CIV. UNEMPLOYMENT RATE, PERCENT	5.7	5.6	5.5	5.6	5.4	5.4	5.6	5.4	5.3	5.4	5.3	5.4	5.1
NONFARM PAYROLL EMPLOYMENT, MIL.	104.7	105.0	105.3	105.5	106.1	106.3	106.4	106.7	107.0	107.4	107.6	108.1	108.3
AVG. WEEKLY HOURS, MFG.	41.0	40.9	41.2	41.0	41.1	41.1	41.0	41.2	41.2	41.2	40.8	41.0	41.0
INITIAL CLAIMS UNEMP. INS., THOUS.	321.6	308.0	304.5	310.8	304.1	325.4	305.1	292.8	295.4	300.5	309.0	292.5	308.8
CONSUMER SECTOR													

RETAIL SALES, BIL. \$	131.9	133.7	133.2	134.1	135.0	136.7	136.1	135.8	137.8	139.5	139.2	140.1	139.5
PERCENT	1.2	1.3	-0.3	0.7	0.7	1.2	-0.4	-0.2	1.5	1.2	-0.2	0.7	-0.4
TOTAL AUTO SALES, MIL. UNITS, A.R.	11.1	10.6	10.5	10.4	11.0	10.7	10.6	10.6	9.8	10.2	11.5	9.8	9.9
DOMESTIC	7.9	7.5	7.2	7.3	7.8	7.8	7.4	7.6	6.8	7.2	8.4	7.0	7.1
IMPORTED	3.2	3.1	3.3	3.0	3.1	3.0	3.2	3.1	3.0	2.9	3.1	2.7	2.8
PERSONAL INCOME, BIL. \$, A.R.	3946.7	3985.9	4001.0	4021.4	4044.9	4075.3	4091.8	4114.7	4175.5	4165.2	4200.8	4272.9	4315.3
PERCENT	0.6	1.0	0.4	0.5	0.6	0.8	0.4	0.6	1.5	-0.2	0.9	1.7	1.0
DISP. PERS. INC., BIL. \$, A.R.	3376.7	3406.4	3357.6	3441.5	3465.3	3491.1	3505.9	3525.5	3580.0	3567.9	3599.5	3659.7	3699.7
PERCENT	1.0	0.9	-1.4	2.5	0.7	0.7	0.4	0.6	1.5	-0.3	0.9	1.7	1.1
REAL DISP. PERS. INC., BIL. \$, A.R.	2768.0	2779.2	2721.5	2776.5	2788.4	2797.0	2802.2	2802.0	2832.5	2818.5	2834.3	2863.4	2889.6
PERCENT	1.0	0.4	-2.1	2.0	0.4	0.3	0.2	0.0	1.1	-0.5	0.6	1.0	0.9
PERS. CONSUMP. EXP., BIL. \$, A.R.	3125.4	3149.0	3161.3	3190.9	3231.5	3241.7	3271.7	3270.2	3307.7	3325.4	3346.0	3357.9	3375.7
PERCENT	0.5	0.8	0.4	0.9	1.3	0.3	0.9	0.0	1.1	0.5	0.6	0.4	0.5
REAL PERS. CONSUMP. EXP., BIL. \$, A.R.	2562.0	2569.2	2562.5	2574.3	2600.3	2597.3	2615.0	2599.1	2617.1	2626.9	2634.6	2627.2	2636.6
PERCENT	0.5	0.3	-0.3	0.5	1.0	-0.1	0.7	-0.6	0.7	0.4	0.3	-0.3	0.4
HOUSING SECTOR													

HOUSING STARTS, THOU. UNITS, A.R.	1511.0	1528.0	1576.0	1392.0	1463.0	1478.0	1459.0	1463.0	1532.0	1567.0	1577.0	1690.0	1498.0
SINGLE-FAMILY	1095.0	1169.0	1087.0	1001.0	1088.0	1067.0	1076.0	1039.0	1136.0	1138.0	1141.0	1202.0	1045.0
HOUSING PERMITS, THOU. UNITS, A.R.	1429.0	1476.0	1449.0	1436.0	1493.0	1420.0	1464.0	1394.0	1516.0	1516.0	1566.0	1507.0	1404.0

BUSINESS SECTOR

	Feb-88	Mar-88	Apr-88	May-88	Jun-88	Jul-88	Aug-88	Sep-88	Oct-88	Nov-88	Dec-88	Jan-89	Feb-89
MFG. ORDERS, DUR. GOODS, BIL. \$	114.2	113.1	116.8	115.4	125.4	116.1	122.8	119.3	122.8	123.0	132.1	128.3	123.7
PERCENT	1.0	-1.0	3.3	-1.3	8.7	-7.4	5.8	-2.8	2.9	0.2	7.4	-2.9	-3.6
NONDUR. CAP. GOODS ORDERS, BIL. \$	33.8	31.9	33.7	31.5	35.5	36.2	38.8	36.9	34.6	35.8	39.4	40.3	36.7
PERCENT	-0.1	-5.6	5.7	-6.6	12.5	2.1	7.2	-10.2	-0.7	3.5	10.1	2.2	-8.9
NONRES. CONST. PUT IN PLACE BIL., \$	125.7	128.7	126.5	129.8	129.6	130.4	131.4	130.2	130.7	131.5	134.1	137.7	NA
INVENTORY CHANGE BK. VAL., BIL. \$ A.R.	44.6	30.0	45.2	57.8	67.8	52.9	95.5	76.9	3.9	37.9	82.1	67.5	NA
INVENTORY/SALES RATIO, TOTAL BUSINESS	1.52	1.50	1.51	1.51	1.50	1.50	1.50	1.51	1.50	1.50	1.49	1.49	NA

INFLATION INDICATORS

CPI (PERCENT)	0.2	0.3	0.4	0.4	0.3	0.4	0.3	0.4	0.4	0.3	0.4	0.6	0.4
PPI FIN. GOODS (PERCENT)	0.0	0.4	0.3	0.3	0.2	0.6	0.3	0.6	0.1	0.2	0.5	1.0	1.0
HLTY. EARNNGS., PR. NONFARM (PERCENT)	0.1	0.2	0.6	0.4	-0.1	0.4	0.1	0.4	0.7	-0.1	0.2	0.6	0.1
GOLD, \$ PER OZ. (N.S.A.)	442.0	443.6	451.7	451.1	451.3	437.6	431.3	413.5	406.8	420.2	419.1	403.9	387.5

FOREIGN TRADE BIL. \$, (S.A.A.R)

EXPORTS	294.2	322.5	312.3	329.7	315.4	318.2	329.9	335.9	333.8	330.5	348.7	333.6	NA
IMPORTS (CUSTOMS)	432.7	439.7	417.9	428.8	455.4	416.4	457.7	446.1	439.2	458.4	480.6	447.5	NA
DEFICIT	-158.5	-117.2	-105.6	-99.0	-140.0	-96.2	-127.8	-110.3	-105.4	-127.9	-131.9	-113.9	NA

U.S. EXCHANGE RATE (N.S.A)

MULTILATERAL	91.1	89.7	89.0	89.7	92.6	96.5	98.3	97.9	95.1	91.9	91.9	95.1	95.8
PERCENT	2.0	-1.5	-0.9	0.9	3.2	4.3	1.8	-0.4	-2.9	-3.4	0.0	3.5	0.7
CAN \$/\$	1.27	1.25	1.24	1.24	1.22	1.21	1.22	1.23	1.21	1.22	1.20	1.19	1.19
YEN/\$	129.2	127.1	124.9	128.8	127.5	133.0	133.8	134.3	128.7	123.2	123.6	127.4	127.7
DM/\$	1.70	1.68	1.67	1.69	1.76	1.85	1.89	1.87	1.82	1.75	1.76	1.84	1.85
\$/POUND	1.76	1.83	1.88	1.87	1.78	1.71	1.70	1.68	1.74	1.81	1.83	1.77	1.75

MONEY AND CREDIT

M1, BIL. \$	760.1	763.8	771.2	771.1	776.5	782.5	782.4	783.7	785.4	786.6	790.2	786.2	787.4
PERCENT, A.R.	2.7	6.0	12.3	-0.2	8.7	9.7	-0.2	2.0	2.6	1.8	5.6	-5.9	1.8
M2, BIL. \$	2950.8	2969.3	2990.3	2990.8	3013.1	3023.9	3029.7	3035.0	3042.2	3059.1	3069.4	3066.0	3070.3
PERCENT, A.R.	8.6	7.8	8.8	3.9	5.5	4.4	2.3	2.1	2.9	6.9	4.1	-1.3	1.7
TOTAL RESERVES, BIL. \$	59.6	59.8	60.4	60.4	60.6	61.2	61.1	61.0	61.0	61.1	61.0	60.5	60.5
PERCENT, A.R.	2.3	3.8	13.1	-0.2	5.5	12.6	-2.9	-1.9	-0.8	2.0	-1.5	-8.2	-1.1
NONBORROWED RESERVES, BIL. \$	59.2	58.0	57.4	57.8	57.6	57.8	57.8	58.2	58.7	58.2	59.3	58.9	59.0
PERCENT, A.R.	17.8	-21.3	-12.3	8.9	-4.7	5.2	1.1	6.6	10.8	-9.1	24.4	-7.4	2.4
C&I LNS. + COMM. PAPER, BIL. \$ (N.S.A.)	375.8	382.1	387.0	392.9	393.1	390.8	389.2	388.1	394.3	397.5	402.0	408.8	418.8
PERCENT, A.R.	17.3	21.9	16.7	19.9	0.5	-6.7	-4.8	-3.4	21.1	10.1	14.6	22.3	33.5

INTEREST RATES (N.S.A.)

FED FUNDS RATE	6.6	6.6	6.9	7.1	7.5	7.8	8.0	8.2	8.3	8.4	8.8	9.1	9.4
T-BILL, 3-MO.	5.7	5.7	5.9	6.3	6.5	6.7	7.1	7.2	7.4	7.8	8.1	8.3	8.5
T-BOND, 10 YR.	8.2	8.4	8.7	9.1	8.9	9.1	9.3	9.0	8.8	9.0	9.1	9.1	9.2
T-BOND, 30 YR.	8.4	8.6	9.0	9.2	9.0	9.1	9.3	9.1	8.9	9.0	9.0	8.9	9.0
CORPORATE AAA BONDS	9.4	9.4	9.7	9.9	9.9	10.0	10.1	9.8	9.5	9.5	9.6	9.6	9.6
MORTGAGE COMMITMENT RATE	9.9	9.9	10.2	10.5	10.5	10.4	10.6	10.5	10.3	10.3	10.6	10.7	10.7

STOCK MARKET

DOV JONES 30 INDUSTRIALS	1980.7	2044.3	2036.1	1988.9	2104.9	2104.2	2051.3	2080.1	2144.3	2099.0	2148.6	2234.7	2304.3
STANDARD & POOR'S 500	258.1	265.7	262.6	256.1	270.7	269.1	263.7	268.0	277.4	271.0	276.5	285.4	294.0

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REVIEW & OUTLOOK

The Quality of Investment

The morality play isn't going according to script. The greedy Eighties are supposed to be an era of free-spending hedonism. The current prosperity, the liturgy goes, is based on a consumption binge slighting investment for the future. Soon the party will be over and the piper will have to be paid. There will be much gnashing of teeth, rending of garments and hocking of BMWs.

This jeremiad has been in fashion for several years now despite the inconvenience of sustained prosperity in general and the current investment boom in particular. The standard Commerce Department Survey finds that businesses plan to increase capital investment this year by 9.9%, after a 10.3% boost in 1988. And of course, we still have no signs of capacity bottlenecks while well into the sixth year of a business expansion. Somehow investment has been enough to keep output growing for a record number of years.

So it might be a good idea to take another look at the statistic behind the notion of an investment dearth. In the National Income Accounts, *net private domestic investment as a percent of GNP* comes out lower in the 1980s than in the 1970s. Therefore, the argument goes, we must cut consumption and leave more savings to flow into investment. And we must increase taxes to close the deficit so money borrowed by the government can flow into investment. And particularly, we must stop borrowing from abroad to pay for imports, leaving foreign debts for future generations.

Now of course, productive investment is essential to future growth and prosperity. But the National Income Accounts were established in a Keynesian era to answer Keynesian questions; "investment" is not what produces in the future, but what uses up savings to prevent a shortage in total demand. Keynes, remember, said digging holes and filling them would be fine with him.

Predictably, then, the classification of investment is somewhat slapdash. Octopus Industry's fifty-first Lear Jet is investment, but your son's engineering education is consumption. A personal auto is consumption, even if it lasts five years, indeed even if it's used in business. The same auto purchased by Hertz is investment. The same with personal computers.

Then there is the problem of depreciation. *Net* investment is gross investment less depreciation, someone's guess about how fast the existing capital stock is wearing out. Gross investment actually has been quite strong for the past five years, but bigger depreciation allowances keep net investment relatively low.

Indeed, economist Alan Reynolds points out that while depreciation is deducted to get *net* investment, it's not deducted from *gross* national product; this leaves the percent of GNP comparison suspect. And of course, if policies succeed and GNP grows, the same investment will be a lower percentage. Also, in the 1980s there has been almost no inflation in the costs of capital goods; in the case of computers, prices have declined. But consumer goods have inflated each year, so nominal comparisons create a phony appearance of a capital slump and consumption binge.

With all of these problems measuring the *quantity* of investment, it might be worth thinking a bit about the *quality* of investment, which in fact is more important to the future. Economists John Rutledge and Deborah Allen point out that in the 1970s inflation and high tax rates distorted investment, inducing people not to replace aging factories but to hedge against inflation and take advantage of tax shelters by building hotels, condominiums and shopping centers. That spending was measured as investment, as of course were all wells drilled in search of \$50-a-barrel oil. The 1970s investments turned out not to be today's seed corn, but today's problem loans.

A factory allowed to decay into obsolescence, Mr. Rutledge and Ms. Allen point out, is the rough equivalent of a factory bombed out of existence. So the United States at the end of the 1970s resembled Japan and Germany at the end of World War II. In the early Eighties inflation was quashed and taxes were recast to encourage productive investment. The result resembled a reverse Marshall Plan, with spending to replace depleted capital, a rebounding manufacturing center and high foreign investment.

When it comes to imports, indeed, Americans were not blowing their money on CD doodads and big-screen TVs, but spending on the sorts of things John Calvin would approve of. A third of the worsening trade balance in the 1980s was due to American purchases of foreign capital equipment. Another quarter of the deficit was due to purchases of industrial supplies and materials. If Americans went on a global buying binge in the Eighties, more than half the money was spent enlarging U.S. productive capacity.

What this means is that human nature did not change during the 1980s. As usual, people took advantage of good times to buy things they wanted or needed. As usual, people planned for the future by investing as best they could. And as usual, doom and gloom oracles got the whole situation flummoxed up.

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LEVEL 3 - 1 OF 19 STORIES

PR Newswire

February 21, 1989, Tuesday

DISTRIBUTION: TO BUSINESS DESK

LENGTH: 540 words

HEADLINE: TO AVOID 'TRADING PLACES,' U.S. MUST GROW THROUGH

DATELINE: NEW YORK, Feb. 21

KEYWORD: EASTMAN KODAK CEO ADDRESSES ABNY

BODY:

NEW YORK, Feb. 21 /PRN/ -- The U.S. faces the choice of "trading goods or trading places," with countries whose standards of living are less than our own, according to Colby H. Chandler, chairman and chief executive officer of Eastman Kodak Company (NYSE: EK).

Speaking to a breakfast meeting of the Association for a Better New York (ABNY), Chandler said that in order for the country to continue to be a world leader, it will have "to put its economic house in order."

Chandler noted that while reducing the federal deficit must be an economic priority, the nation's agenda can be put in the simpler terms of preserving and enhancing a manufacturing base. "We need to ask ourselves: Do we want to manufacture quality goods here and have increased economic growth, or do we want to accept status as a low-cost, cheap labor country," Chandler said.

Chandler admitted that many Americans may have become "anesthetized" to dire warnings on the consequences of the budget and trade deficits. "We are no longer paying attention," he said.

"While we are all aware that America has a trade deficit, it seems very abstract to most of us," Chandler said. "And few of us have stopped to think what it actually means to us in practical terms.

"What it means is that the debate over whether the U.S. is deindustrializing is essentially irrelevant. The fact is America cannot do away with its manufacturing base."

In order just to keep its foreign debt from growing, the United States must begin running a trade surplus of \$50 billion a year, according to Chandler. That would be a \$200 billion turnaround from the current \$150 billion trade deficit.

Chandler offered three major recommendations for bringing "some vibrancy" to the economy and "managing a successful adjustment."

-- First, the United States must pursue sound economic policies that will foster a substantial increase in savings to finance investment.

-- Second, there must be improved access to foreign markets.

-- Third, foreign markets must grow in order to accommodate increased U.S. exports.

On the economic policy front, Chandler noted that the budget deficit has continued to rise despite attempts by Congress and past administrations to attack it. "The problem will not grow away or go away," he said. "America must work towards a balanced budget with spending cuts and revenue increases sharing in the pain."

Chandler said that any new taxes should reward savings and investment rather than consumption and debt. He pointed out that a

PR Newswire, February 21, 1989

5 percent value-added tax, even with exemptions on food, health and housing costs, could raise \$80 billion a year toward deficit reduction.

"Failure by our political leaders to act today means a tomorrow with: higher interest rates (which are already too high), less investment (which is already too low), and probably an overvalued dollar (when a lower one is needed to encourage exports)," Chandler said.

"In other words, failure to produce deficit reduction will make it difficult for American manufacturers to produce.

CONTACT -- Paul C. Allen of Eastman Kodak, 716-724-5802

LEVEL 3 - 2 OF 19 STORIES

Proprietary to the United Press International 1989

February 8, 1989, Wednesday, BC cycle

SECTION: Regional News

DISTRIBUTION: New York

LENGTH: 326 words

HEADLINE: Kodak announces record profits and sales in 1988

BYLINE: By CHARLES F. PORCARI

DATELINE: ROCHESTER, N.Y.

KEYWORD: Earn-Kodak

BODY:

Buoyed by a strong fourth quarter, Eastman Kodak Company Wednesday announced record sales and earnings for 1988, although rumors of white-collar job cuts remain.

The Rochester-based photo giant reported year-end net earnings of \$1.40 billion, or \$4.31 a share, an increase of 19 percent over the 1987 figures of \$1.18 billion, or \$3.52 per share.

Sales for 1988 totaled \$17.03 billion, a jump of 28 percent from the 1987 total of \$13.31 billion, Kodak reported.

The results included figures from Sterling Drug Company, acquired by Kodak last February, but company officials said sales and earnings would have reached record proportions anyway.

Fourth quarter net earnings were \$312 million, or \$.96 a share, up 29 percent from fourth quarter 1987 per share earnings of \$.75.

"I think the fourth quarter was the key, performance was better than anticipated as sales picked up considerably near the end," said Eugene Glazer, a vice president at Dean Whitter Reynolds, who follows Kodak.

Glazer said Kodak's core business of cameras and film remained strong in 1988, allowing the company to digest the absorption of Sterling Drug.

"It'll be five years or so before we can tell if Sterling was digested completely, but numbers like that help," Glazer said.

Kodak officials declined to comment about rumors of selected white-collar layoffs in some of the firm's operating divisions, although Kodak Chairman and Chief Executive Officer Colby Chandler was expected to make an announcement to employees Thursday.

"Administrative type positions are always looked at when costs need to be cut, In 1989 I think you'll see some peering," Glazer said.

Proprietary to the United Press International, February 8, 1989

In a prepared statement, Chandler said the company would not be resting on its laurels in 1989.

'With the organizational components of our long-term strategy now in place, we are focusing our efforts and our investments on value-adding aspects of our principal business sectors,' Chandler said.

LEVEL 3 - 3 OF 19 STORIES

PR Newswire

November 30, 1988, Wednesday

DISTRIBUTION: TO BUSINESS DESK

LENGTH: 332 words

HEADLINE: KODAK SALES TO REACH \$1 BILLION IN JAPAN IN 1989, CHANDLER SAYS

DATELINE: HARTFORD, Conn., Nov. 30

KEYWORD: EASTMAN KODAK PREDICTS JAPAN SALES

BODY:

HARTFORD, Conn., Nov. 30 /PRN/ -- Kodak's total sales in Japan next year are expected to reach \$1 billion, more than four times the 1985 sales in that country, Colby H. Chandler, chairman and chief executive officer of Eastman Kodak Company (NYSE: EK), told the Hartford Society of Financial Analysts today.

Chandler said the company's increased thrust in the Japanese market is paying dividends with revenues up more than 25 percent this year.

"It is interesting to note that Kodak sales in the U.S. reached the billion dollar milestone 26 years ago," Chandler said. "In Japan today -- as was true of Kodak in this country in 1962 -- we have only just begun."

As evidence of Kodak's "aggressive effort" to significantly increase Kodak's share of the Japanese imaging market, the world's second largest market for such products, Chandler cited the opening of the new Kodak Research and Development Center in Japan last month.

The center, which currently employs 100 scientists and engineers, will help Kodak match products specifically to unique Japanese needs, Chandler said. It also will let the company enter the Japanese scientific network and link Japan to the Kodak network of international research and development labs.

Other recent thrusts in Japan included the forming of a photofinishing joint venture with Imagica Corporation, the forming of K. K. Kodak Information Systems to market micrographic and business imaging systems, and the opening of a technical center in Tokyo to assist customers with photofinishing, consumer and professional products and services and to test new Kodak products for suitability in the Japanese market.

The company also announced its first manufacturing operation in Japan for the finishing (cutting and packaging) of selected graphic arts films for that market. It will be operational by the end of this year.

CONTACT -- Henry J. Kaska of Eastman Kodak, 716-724-4642

LEVEL 3 - 4 OF 19 STORIES

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November 30, 1988, Wednesday, BC cycle

SECTION: Financial Report.

LENGTH: 133 words

HEADLINE: KODAK SEES ONE BILLION DLR 1989 SALES IN JAPAN

DATELINE: HARTFORD, CONN., NOV 30, REUTER

BODY:

Eastman Kodak Co <EK> said it expects its total sales in Japan next year to reach one billion dlrs, more than four times 1985 sales in that country.

Colby Chandler, chairman and chief executive officer, told analysts that the company's thrust in the Japanese market has resulted in a 25 pct increase in revenues from that country this year.

Chandler also said that the introduction of a new family of superior films for 35-mm photographers was one of several factors supporting the company's expectations of continuing record performance by the company in 1989.

Chandler said the new Ektar family of films is experiencing "extremely positive" customer and dealer reaction in Europe and Japan, where the film is now being marketed. United States introduction is scheduled for early 1989.

LEVEL 3 - 5 OF 19 STORIES

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November 21, 1988, Monday, NORTH SPORTS FINAL

SECTION: BUSINESS; Pg. 5; C

LENGTH: 794 words

HEADLINE: A student of business, Kodak chief stresses manufacturing

BYLINE: Associated Press

DATELINE: ROCHESTER, N.Y.

BODY:

Colby Chandler, chairman and chief executive of Eastman Kodak Co., has spent 38 years learning the lessons of business, the theories of economics and the inside-out story of the world's largest photography company.

Now, after five years at the helm of Kodak, Chandler is ready to take his message on the future of manufacturing to the masses.

So move over, Lee Iacocca, because here comes Colby "America won't make it without manufacturing" Chandler.

At 63, the low-key engineer is learning how to become a standup spokesman for corporate America.

"Watching the swing toward a service-intensive society and listening to some parties say that's good is scary," said Chandler in an interview at Kodak's headquarters in Rochester. "I have no intention of talking to the walls on this subject."

Kodak's chief has been out preaching the manufacturing gospel to business groups, college students, politicians and anybody else who will listen. The company also commissioned a study by three leading economists on the importance of manufacturing, and it started its first public affairs advertising campaign on the issue.

Chandler also is using his last few weeks as chairman of President Reagan's Export Council, the chief advisory group to the Department of Commerce, to drum up support.

"The importance of manufacturing to the economy has been something that's been so obvious to me, and I'm sure to others like me, that it might not have ever occurred to us that it wasn't obvious to everyone else," he said.

Though leaders of service industries might disagree, Chandler claims that one job making a car, or a copier, or a computer, is 10 times more valuable to the economy than a job selling insurance or waiting on customers in a bank or making airline reservations.

The percentage of workers employed in manufacturing in America - 20 percent - is lower than at any time this century, according to the Kodak-commissioned

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study "The Case For Manufacturing in America's Future."

What that means, Chandler said, is that the large "multiplier effect" that manufacturing has on stimulating the economy - through higher wages, buying supplies and raw materials and creating new and improved products - is drying up.

"It's a very critical . . . edge that we walk," Chandler said. "We're not the country with leading productivity gains. That's a sign. When we reach the real crisis, we will have gone so far that bringing it back is going to take decades and decades."

The best way to help manufacturing in the immediate future would be to eliminate the federal deficit, Chandler said. But for the long term, he suggested:

- Urging the government to make education and other people-oriented benefits a priority.

- Using spending and tax policies to encourage investment in new technology and research.

- Implementing an incremental investment tax credit that would provide incentives for companies to expand a plant or buy new equipment.

- Altering the nation's tax structure to put a higher emphasis on taxing consumption rather than the current system of taxing investment and saving.

Chandler has always had a reputation on Wall Street as "Mr. Long Term," even before he took over as chairman of Kodak.

He came to the company in 1950 after graduating from the University of Maine with a physics degree. He worked as a quality control engineer and held various management positions.

He received a master's degree in management from Massachusetts Institute of Technology in 1964 and directed the development of Kodak's Ektaprint copiers and duplicators in 1973. He was named president of the company in 1977 and chairman in 1983.

As chairman, Chandler has sent Kodak charging into Japan and given assembly-line workers almost complete control over products they make.

And he's added aspirins, batteries and household cleaners to the list of products Kodak sells through new ventures and the acquisition of Sterling Drug Co.

"He never seemed as concerned with the nuts-and-bolts stuff of today or tomorrow. What interested him was Kodak 3, 5, 10, 20 years from now," said Brian Fernandez, stock analyst with Brean Murray, Foster Securities.

When Chandler began restructuring Kodak's several years ago to cut out layers of management and give each employee more responsibility, he said he restructured his job to include a more active role in outside affairs that affect the company.

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But it appears that no one, especially the politicians, seems to care about the eroding manufacturing base of the country, Chandler said.

He said he's learning how to handle himself in the political world, where "almost everything that is said has little substance," and in the media, where words have to be carefully chosen.

GRAPHIC: PHOTO: Colby Chandler.

TERMS: EXECUTIVE; INTERVIEW; BIOGRAPHY

LEVEL 3 - 6 OF 19 STORIES

The Associated Press

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November 17, 1988, Thursday, AM cycle

SECTION: Business News

LENGTH: 903 words

HEADLINE: Kodak Chairman Trying To Spread the Manufacturing Gospel

BYLINE: By RANDOLPH PICHT, AP Business Writer

DATELINE: ROCHESTER, N.Y.

KEYWORD: Personal File-Chandler

BODY:

Colby Chandler, chairman and chief executive officer of Eastman Kodak Co., has spent 38 years learning the lessons of business, the theories of economics and the inside-out story of the world's largest photography company.

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The Associated Press, November 17, 1988

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It's basic public relations, Chandler admits, but it's something he's only starting to understand.

If government officials were doing their jobs correctly, he said he wouldn't have to worry about developing an expertise in communications.

"They're patching up problems and they're responding to special interests and there's very little sitting back in a statesmanlike way saying where do we want to lead this country," Chandler said.

"You perhaps could make an observation that they can't. My feeling is they must."

GRAPHIC: LaserPhoto ROC1 of Nov. 15

LEVEL 3 - 7 OF 19 STORIES

The Associated Press

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November 16, 1988, Wednesday, BC cycle

ADVANCED-DATE: November 18, 1988, Friday, BC cycle

SECTION: Business News

LENGTH: 903 words

HEADLINE: Kodak Chairman Trying to Spread the Manufacturing Gospel

BYLINE: By RANDOLPH PICHT, AP Business Writer

DATELINE: ROCHESTER, N.Y.

KEYWORD: Personal File-Chandler

BODY:

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The Associated Press, November 16, 1988

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The Associated Press, November 16, 1988

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GRAPHIC: LaserPhoto ROC1 of Nov. 15

LEVEL 3 - 8 OF 19 STORIES

PR Newswire

October 20, 1988, Thursday

DISTRIBUTION: TO NATIONAL AND BUSINESS DESK

LENGTH: 425 words

HEADLINE: "AMERICA: ARE WE RESPONSIBLE FOR IT?"

DATELINE: ITHACA, N.Y., Oct. 20

KEYWORD: KODAK'S CHANDLER

BODY:

ITHACA, N.Y., Oct. 20 /PRN/ -- America's ability to live up to its promise depends on putting an end to adversarial posturing and making the tough-but-ethical choices together, says Colby H. Chandler, chairman and chief executive officer of Eastman Kodak company (NYSE: EK).

Honored as the 1988 Robert S. Hatfield Fellow at Cornell University, Chandler told his audience: "In our slide from being 'undisputed number one,' we (America) lost more than our technology, our positive trade balance, and jobs. We lost something basically American -- our national character. We lost our national resolve to make the tough choices, together."

"In reviewing this loss of ethical leadership, Chandler indicated that America has lost its public and private heroes. "Our heroes bring us back to the basic values: values like our ethical behavior, our faith in fairness, our moral responsibilities to our fellow citizens."

Chandler made several recommendations for reviving this country's sense of team play and our responsibilities, citizen-to-citizen.

He asked each American to think through the consequences of their actions, and, in doing so, to keep the rights and considerations of others in mind. He also encouraged Americans to "bring their hearts" into their debates, saying "the heart is a terrible thing to ignore."

His third hope -- aimed at the young Americans who will be the shapers of this country's future -- is that everyone will get involved "actively and regularly in the business of America." Our national resolve must come, he said, from every American.

Chandler encouraged Americans to bring back their heroes, especially private ones. "In many ways, our private heroes are the great connectors -- bringing our lives together. They encourage us to strive for common goals with uncommon efforts."

"A final recommendation by Chandler was the need for our citizens to reintroduce a good old-fashioned American trait -- common sense. Too often, he said, America keeps taking the easy way out -- instead of trying "some common sense ... for the common good."

The Kodak executive concluded his address to Cornell faculty, students, and friends, by issuing a challenge: "If the question is: who is responsible for restoring the ethical and moral fabric of America? I hope all of us find the collective courage and character to answer: Now ... it is our turn

PR Newswire, October 20, 1988

CONTACT -- Darlene J. Aiken of Eastman Kodak Company,
716-724-4726

LEVEL 3 - 9 OF 19 STORIES

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The Reuter Business Report

October 14, 1988, Friday, BC cycle

LENGTH: 344 words

HEADLINE: EASTMAN KODAK SEES HIGHER 1988 NET PROFIT

BYLINE: By Richard Walker

DATELINE: CHICAGO

KEYWORD: KODAK

BODY:

Eastman Kodak Co. should outperform the 1988 estimates of Wall Street analysts as they have overestimated how the company's purchase of Sterling Drug Inc. will affect its earnings, chairman Colby Chandler said Friday.

The photography giant is having another banner year, Chandler said, after posting \$13.3 billion in 1987 sales. The company acquired New-York based Sterling for \$5.1 billion in February.

Analysts had said the purchase would hurt Kodak's 1988 per-share earnings, and had estimated them as ranging between \$4.25 to \$4.35. But Chandler said Wall Street had been too pessimistic on how the Sterling buy would hurt the earnings.

Chandler told Reuters he was "bullish" on the company's 1988 outlook, but declined to discuss the outlook for its third or fourth quarter earnings.

Chandler said Kodak was on track with its business plan, so that the Sterling acquisition should dilute earnings by about 15 cents to 25 cents a share, in line with previous estimates.

Kodak's friendly takeover of Sterling was hailed by analysts as its first major diversification move. Although the company had made small forays into office products, batteries and computers in recent years, Sterling would give Kodak a strong foothold in the \$110 billion world pharmaceuticals market, they said.

And Chandler was confident that Kodak would prosper well all around. "This is going to be another record year, and I would be able to say that even without Sterling," he said.

"I think we have some surprises left on the upside," he added, as Kodak's unit product volume is up 9 percent from last year, not counting its new drug company.

By 1989, he said Sterling's negative earnings impact should decrease, and the drug company should start helping cash flow. Sterling should contribute to both cash flow and earnings by 1990, he added.

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Eastman Kodak predicts that a sharp increase in health-sector business in the next decade will outstrip growth in its photography and other business lines, Chandler added.

Shares of Kodak rose 62.5 cents Friday, closing at \$48.

LEVEL 3 - 10 OF 19 STORIES

PR Newswire

October 5, 1988, Wednesday

DISTRIBUTION: TO BUSINESS DESK

LENGTH: 296 words

HEADLINE: KODAK'S CHANDLER STRESSES NEED FOR QUALITY IMPROVEMENTS

DATELINE: NEW YORK, Oct. 5

KEYWORD: EASTMAN KODAK ADDRESSES QUALITY FORUM

BODY:

NEW YORK, Oct. 5 /PRN/ -- If our country is to compete effectively in the global marketplace, we must build quality into every step of the process of creating services and products that satisfy customer needs, says Colby I. Chandler, chairman and chief executive officer of Eastman Kodak Company (NYSE: EK) and national chairman of Quality Month '88.

Delivering the keynote address at the National Quality Forum at the Vista International Hotel here, Chandler said, "The need for improved quality is critical. It is, without question, a matter of survival for American service and manufacturing companies."

Chandler pointed out that this year's theme "Quality: Beyond Customer Satisfaction ... To Customer Delight" refers to the delivery of products and services that exceed expectations. This means, "Anything you can do for your customer -- whether internal or external -- to have him or her say, 'I am absolutely delighted.'"

"Swiftly changing technology and innovative new products allow any given number of competitors in a marketplace the ability to satisfy a customer. But going beyond satisfaction to delight a customer will provide a distinct advantage to the company that does it first and consistently well," he said.

He also noted that as a result of various quality improvement tools and approaches, Kodak productivity advanced last year by more than 14 percent over 1986. This was an increase of more than four times the U.S. average.

Chandler stated that quality improvements are an imperative for the U.S. "They are a priority that must be promoted and fully understood by both the business community and the general public."

CONTACT -- Darlene J. Aiken of Eastman Kodak, 716-724-4726

LEVEL 3 - 11 OF 19 STORIES

Proprietary to the United Press International 1988

August 12, 1988, Friday, BC cycle

SECTION: Regional News

DISTRIBUTION: New York

LENGTH: 193 words

HEADLINE: Kodak increases dividend by 11 percent

DATELINE: ROCHESTER, N.Y.

KEYWORD: Kodak-Dividend

BODY:

The board of directors of Eastman Kodak voted Friday to increase the company's quarterly cash dividend by 5 cents from 45 cents to 50 cents, a spokesman said.

The dividend, an 11 percent increase, will be paid Oct. 3 to shareholders of record Sept. 1, spokesman Henry Kaska said.

Colby Chandler, chairman and chief executive officer of the Rochester-based photographic products giant, said the higher dividend reflected confidence in Kodak's performance 'not only for 1988 but for the long term as well.'

'We are seeing positive returns from the significant steps we have taken in the past few years,' Chandler said. 'Not the least of these were the restructuring of the company into business units and our continuing drive for productivity improvement and cost control, all of which are making Kodak a more aggressive, more competitive company.'

In a prepared statement, Chandler also said the dividend increase showed the merger of Kodak and the Sterling Drug Co. is working smoothly.

The dividend increase is the second this year for Kodak. Kaska said on Jan. 4, 1988, the company boosted its dividend from 42 cents to 45 cents a share.

LEVEL 3 - 12 OF 19 STORIES

PR Newswire

May 11, 1988, Wednesday

DISTRIBUTION: TO BUSINESS DESK

LENGTH: 839 words

HEADLINE: CHANDLER FORESEES VIGOROUS GROWTH

DATELINE: TORONTO, May 11

KEYWORD: EASTMAN KODAK ANNUAL MEETING

BODY:

TORONTO, May 11 /PRN/ -- By continually seeking new approaches to doing business, Eastman Kodak Company (NYSE: EK) will reach new levels of performance, Colby H. Chandler, Kodak chairman and chief executive officer, said in remarks prepared for delivery here today.

Speaking at the company's annual meeting at Ryerson Polytechnic Institute -- the first Kodak annual meeting ever held outside the United States -- Chandler predicted that 1988 would be another year of "vigorous" growth.

"In fact," Chandler said, "I believe we will exceed \$17 billion in revenue, compared with \$13.3 billion in 1987." He added that Kodak earnings in 1988 would meet or exceed current analyst estimates, real unit growth would continue at a multiple of worldwide real GNP, and "volume will continue to be the key driver in this improving performance."

Chandler estimated that about \$2.7 billion of Kodak's revenue in 1988 would be contributed by the recently acquired Sterling Drug Company. With that acquisition, he said, Kodak has brought together the key elements of its strategic vision -- sources of future growth from four core businesses:

-- Photography, which he described as "an expanding technology rather than a maturing one," and Kodak's most important source of earnings.

-- Fibers, plastics and chemicals, a core supplier of earnings that will "continue to grow in pace with other manufacturers."

-- Information management, "a high growth layer where we will focus on premium value."

-- Health, which he described as a logical extension of Kodak's science and manufacturing base and "a high growth segment for many years to come." This segment includes Sterling Drug Inc.

Chandler said that while the company may make niche acquisitions in the future, it "has completed the link" among the four growth areas. Having established the organization and the structure to achieve continued growth, the challenge now is to manage it in a climate of continual worldwide change," he said.

PR Newswire, May 11, 1988

Chandler predicted that 1988 would be a year of superior financial performance. In the first quarter, Kodak reported sales increases of 25 percent, and an increase in earnings from operations of 38 percent. Net earnings were up 46 percent.

Kodak Canada Inc. sales were up 25 percent, and earnings from operations showed a 171 percent increase. Net earnings were up 185 percent.

Chandler said Kodak's goal is a return on assets "exceeding 10 percent." In 1987, the company's return on assets was 8.6 percent.

"In addition, we must strive for a return on equity of 20 percent," he said. "We virtually hit this in 1987 with 19 percent, and we expect to do as well in each of the next several years."

Chandler pointed to several examples of the company's new pace and direction:

-- The new breakthrough family of Kodacolor VR films and the enhanced VR-G films, followed by the recent announcement of a new line of Kodacolor Gold films;

-- The new black-and-white, Kodak T-Max P3200 professional film, called "the world's fastest film" and capable of being exposed at indexes up to 50,000 with acceptable results;

-- The new Kodak Create-A-Print enlargement center that allows customers to make their own color enlargements -- a system that took only 22 months from initial concept to introduction.

"Deliberately, relentlessly, we are sending the message that Kodak will not just keep pace in its chosen lines-of-business," Chandler said. "We will set the pace."

To do that, he noted, Kodak has had to change in some fundamental ways:

-- New approaches to business strategy including several joint ventures with prominent worldwide firms;

-- Kodak is clearly becoming more global in executing its business strategy, as is seen in the agreement to build a new color photographic manufacturing plant in China in return for royalties on the new company's production and future opportunities in the emerging China market;

-- A sharper focus on managing operations to achieve higher performance on behalf of customers and shareowners may involve strategic divestitures of businesses that do not create value.

"Our aim is to reach a 'steady state' level where we manage an intelligent ongoing review and divestiture process," Chandler said. "We do not see divestitures as failures, but as business opportunities worth more to someone else."

Chandler added that the company moved "quickly but not recklessly" in the past year to seize practical opportunities. "Far from being a diversification, our growth is a logical extension of our vision. We are guided by a clear vision -- one that will extend our legacy well into the 21st century.

PR Newswire, May 11, 1988

CONTACT -- Ronald C. Roberts of Eastman Kodak, 716-724-4513

LEVEL 3 - 13 OF 19 STORIES

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May 11, 1988, Wednesday, BC cycle

SECTION: Canadian Financial Report. Financial Report.

LENGTH: 247 words

HEADLINE: EASTMAN KODAK CO <EK> TO CONSIDER DIVESTITURES

DATELINE: TORONTO, MAY 11, REUTER

BODY:

Eastman Kodak Co will consider selling operations that are not performing well, chairman Colby Chandler told the company's annual meeting.

"Just as we have a well-managed process for making acquisitions, it is important that these activities be complemented by dropping out of businesses which are not creating value for Kodak shareowners," Chandler said.

If Kodak gets an offer for a business that is "substantially above what its value is to Kodak," the company would consider selling it, president Kay Whitmore said.

Chandler said that for 1988 the company wants to reduce the total cost of waste incurred in its worldwide production of film and paper by 10 pct, following a 15 pct reduction in 1987.

Asked about the presence of methylene chloride, an industrial solvent, in ground water at its Kodak Park facility in Rochester, New York, Chandler said the company believes there is no health hazard to nearby residents.

"We are eager to have qualified consultants conduct tests to verify our belief," he said.

Kodak shareholders approved a previously announced proposal by the board to increase the number of authorized common shares to 950 mln from 500 mln.

The company said in a proxy statement that it does not at present plan to issue any of the newly authorized common stock.

But Kodak said that in the event of an unsolicited tender offer or takeover bid, the increased number of shares would give the board greater flexibility.

LEVEL 3 - 14 OF 19 STORIES

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May 11, 1988, Wednesday, BC cycle

SECTION: Financial Report.

LENGTH: 231 words

HEADLINE: KODAK <EK> NET SEEN MEETING ANALYSTS' ESTIMATES

DATELINE: TORONTO, MAY 11, REUTER

BODY:

Eastman Kodak Co expects 1988 to be another year of vigorous growth with earnings to meet or exceed analysts' current estimates, Chairman Colby H. Chandler said in remarks prepared for the annual meeting.

"I believe we will exceed 17 billion dlrs in revenue, compared with 13.3 billion dlrs in 1987," said Chandler, adding that real unit growth would continue at a multiple of worldwide real GNP and that "volume will continue to be the key driver in this improving performance."

Chandler estimated that about 2.7 billion dlrs of Kodak's revenue in 1988 would be contributed by the recently acquired Sterling Drug Co.

He said that while the company may make niche acquisitions in the future, it "has completed the link" among its four growth areas -- photography, information management, health and fibers, plastics and chemicals.

"Our aim is to reach a 'steady state' level where we manage an intelligent ongoing review and divestiture process," Chandler said. "We do not see divestitures as failures, but as business opportunities worth more to someone else."

Chandler said Kodak's goal is a return on assets "exceeding 10 pct." In 1987, the company's return on assets was 8.6 pct.

"In addition, we must strive for a return on equity of 20 pct," he said. "We virtually hit this in 1987 with 19 pct, and we expect to do as well in each of the next several years."

LEVEL 3 - 15 OF 19 STORIES

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April 22, 1988, Friday, Final Edition

SECTION: FINANCIAL; PAGE 61

LENGTH: 1041 words

HEADLINE: Study of Manufacturers' Problems Part of Campaign to Spark Debate

BYLINE: John M. Berry, Washington Post Staff Writer

BODY:

Colby H. Chandler, chairman of Eastman Kodak Co., yesterday set out to provoke a debate about the economic perils facing the nation -- a debate he says the presidential candidates are ducking.

At a Capitol Hill press conference, Chandler released a study, written by three highly regarded economists, that says the nation's manufacturers remain in serious trouble despite a recent glow of apparent health.

Chandler, who also is chairman of the President's Export Council, an advisory group, said the absence of serious discussion about America's economic future leaves him with a "sense of frustration and deep concern."

"As a nation, we sit upon an economic house of cards," he said. "What is needed is a national debate on the future direction of economic policy that is both realistic and responsible. Yet, I hear little ..."

The debate he seeks would test the strongest political backbone. As part of a plan to reduce federal budget deficits, Chandler called for, among other things, taxation of half of Social Security benefits; higher taxes on cigarettes and distilled spirits; a gasoline tax of 10 cents a gallon; taxation of portfolio income earned in the United States by foreigners; tighter enforcement of the tax laws; and consideration of a new value-added tax.

And in urging new steps to slash the nation's large merchandise trade deficit, Chandler said that "efforts to stabilize U.S. exchange rates at current levels would be misguided and risk a serious recession." The Reagan administration has agreed with other industrial nations to attempt such a stabilization. The proposals were among the recommendations of a study commissioned by Kodak -- actually more a commentary than a study -- written by economists Lawrence H. Summers of Harvard University and Rudiger W. Dornbusch and James Poterba of Massachusetts Institute of Technology.

Chandler said he had sent a letter to each of the Republican and Democratic presidential candidates noting the study's conclusions and asking, "As a leading American manufacturer, I would like to know more about your plans to maintain a strong manufacturing sector and a healthy U.S. economy. I am very concerned that thus far in the presidential campaign these issues are not being addressed in a serious and comprehensive manner."

The letter continued: "Manufacturing is doing relatively well right now because many companies have taken the necessary steps of restructuring and retooling to be world class competitors, and because the dollar has fallen.

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However, the current situation must be viewed as very fragile.

"What guarantee do manufacturers have that the dollar will not skyrocket again because interest rates must go up to keep foreign money flowing into the U.S.? How do we avoid a deep recession or inflation, or both sometime in the next year? What assurance do we have that another October 19 stock market crash will not happen tomorrow?"

"These are all real possibilities that pose real risks to manufacturing and, indeed, the whole economy," Chandler's letter said. "They are serious threats because we have failed to tackle the underlying problems that afflict this economy; namely, a massive budget deficit coupled with very low national savings. The result of this unfortunate combination is that we keep borrowing huge amounts from abroad, our external debt keeps rising, and our vulnerability to shocks keeps mounting."

"We are now half way through the presidential campaign. Yet, none of the remaining candidates are even talking about these problems, let alone offering solutions. Instead, we get promises of new spending programs, and pledges of no tax increases. The country faces painful choices and difficult adjustments. But that is not apparent from listening to the candidates for president of the United States."

So far, Chandler has had no reply to his unusual letter from any of the candidates.

Most of the points made in the study, "The Case for Manufacturing in America's Future," are not new. Nevertheless, taken together they buttress the argument that manufacturing in the United States has borne the brunt of the impact of the economic policies chosen by the federal government in recent years.

A low level of national savings -- exacerbated by large federal budget deficits -- has reduced the supply of capital and hurt investment, the economists said. Such a low savings rate has forced the United States to borrow from abroad to finance a substantial portion of the investment that has occurred.

"This makes trade deficits inevitable," they said, adding, "The composition of U.S. trade implies that a large part of the burden from a rising trade deficit falls on manufacturing industries."

But some actions that would increase the deficit are necessary, too, they said. One of the actions, a partial restoration of the 10 percent tax credit on investments in business equipment that was repealed in the 1986 tax overhaul, would cost about \$ 10 billion a year.

Chandler and the economists also argued strongly that the value of the dollar will have to fall farther if the trade deficit is to be eliminated without plunging the nation into a recession.

"Monetary policies directed at maintaining exchange rates near current levels would be catastrophic for the manufacturing sector," the study said. "In addition to reducing foreign demand for U.S. products and increasing American demand for foreign products, tight monetary policies in defense of the

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exchange rate would raise interest rates and the risk of a recession. Postponing the inevitable exchange rate adjustment only magnifies the ultimate distress."

One of the authors, Summers, conceded that manufacturing's share of the economy has not declined. However, he said, "The concern is not just whether we can sell products but at what price."

Manufacturing has been able to maintain its share of output only by pushing down real factory wages and accepting lower profitability. A healthy manufacturing sector, Summers said, would be one in which growth of the standard of living was comparable to that in other industrial countries -- as opposed to one in which real wages and profits are falling.

The candidates' responses should be interesting -- if they arrive.

GRAPHIC: PHOTO, KODAK CHAIRMAN COLBY H. CHANDLER SAYS A REALISTIC DEBATE ON U.S. ECONOMIC POLICY IS NEEDED. JAMES K.W. ATHERTON

TYPE: ANALYSIS, NATIONAL NEWS

SUBJECT: ECONOMIC CONDITIONS; MANUFACTURING; DEFICIT; PRESIDENTIAL CANDIDATES; UNITED STATES

ORGANIZATION: EASTMAN KODAK CO.

NAME: COLBY H. CHANDLER

LEVEL 3 - 16 OF 19 STORIES

PR Newswire

February 25, 1988, Thursday

DISTRIBUTION: TO BUSINESS DESK

LENGTH: 1263 words

HEADLINE: KODAK SAYS ITS '88 EARNINGS WILL MEET OR EXCEED ANALYSTS' ESTIMATES

DATELINE: NEW YORK CITY, Feb. 25

KEYWORD: EASTMAN KODAK PROJECTS 1988 RESULTS

BODY:

NEW YORK CITY, Feb. 25 -- Eastman Kodak Company (NYSE: EK) today said its estimate of 1988 earnings is well in excess of those published recently by Wall Street analysts.

The estimate by Colby H. Chandler, Kodak chairman and chief executive officer, was conveyed by President Kay R. Whitmore in a talk before financial analysts here today. Whitmore was among speakers explaining the rationale for the new alliance between Kodak and Sterling Drug, Inc.

"Late in 1986, Kodak CEO Colby Chandler advised shareowners that 1987 could well produce record earnings for our company ... and it did," Whitmore said. "I am not here to tell you that 1988 earnings will set another record as that should be obvious.

"But I do bring you this message from Mr. Chandler: Wall Street estimates of Kodak earnings for 1988 were reduced by an average of 35 cents a share between Jan. 1 and Feb. 15. Based on what we have learned from Sterling and what we know about Kodak, we believe that reduction can be put back into analysts' estimates. We now expect that the earnings we report for 1988 will meet or exceed the Street's pre-merger consensus, even after taking into account the dilutive effect of the Sterling merger.

"That is as definitive as we intend to be on the subject of Kodak earnings this year," Whitmore said. "It is also a statement no one of us would have dared to make just a few years ago."

Presenting a positive outlook for the company, he said, "We are optimistic about 1988 ... optimistic about the years beyond ... and above all, optimistic that the benefits of our alliance with Sterling will be very, very substantial."

Whitmore cited these points in "making clear" the rationale for the alliance with Sterling:

-- The alliance is consistent with Kodak strategy. It will enable the company to capitalize on its depth in the chemical sciences, with pharmaceutical interests worldwide in scope.

-- It adds to Kodak's portfolio a highly profitable revenue stream which is consistent with the company's financial goals of return on assets of more than 10 percent, return on equity approaching 20 percent, and earnings from operations produced at a rate that places the company among the top 25 U.S. corporations.

-- It offers very substantial opportunities in terms of cost efficiency through a combination of synergistic research activities, the use of common points of distribution, the purchase of services

PR Newswire, February 25, 1988

and supplies, such as advertising; and consolidation of administrative and manufacturing activities.

-- The alliance provides these benefits in a way that is sure to enhance values with little penalty in terms of operating results on the near term.

Whitmore said the company's move into life sciences is a logical extension of its expertise in chemicals and research. The merger with Sterling, which in time will create one integrated pharmaceuticals business for Kodak, is fully consistent with company strategy to enter the pharmaceutical industry.

He noted that life sciences and health care industry has traditionally enjoyed rates of profitability well above the all-industry average, that health care is expected to grow faster than the gross national product, and that in one segment of the industry -- health care diagnosis and imaging -- Kodak already has a business that exceeds \$1 billion in sales.

Whitmore said that the selection of Sterling was not only a logical choice, it was one of Kodak's top choices from the beginning.

"In the ethical area," he said, "Sterling's efforts complement our own. They are experiencing growing acceptance of their own imaging segments, and they are introducing some important new cardiovascular agents. In the over-the-counter area, they have an excellent business. After successfully penetrating the pharmaceuticals market, we had every intention of entering the over-the-counter market. And Sterling also brings us a well-managed household products business, a business with well-recognized brands and leading market position."

Whitmore said the price paid for Sterling "is competitive, fair, and indicative of Sterling's inherent value." He noted that Sterling posted record earnings in 1987 and has programs in place to continue that level of excellence.

"We expect this merger to generate positive cash flow as early as 1989 and to contribute positively to Kodak earnings as early as 1990," Whitmore said. "So, for Kodak, the long-term reward substantially outweighs the short-term cost."

Paul L. Smith, senior vice-president and director of Finance and Administration, noted that analyst estimates of dilution have understated the earnings potential of Sterling and/or overstated the interest charge Kodak will pay to finance the acquisition.

"First, we believe Sterling's 1988 earnings will be enhanced beyond current analysts' estimates," Smith said. "The combined strength in managing research and development, along with each company's marketing prowess and the savings generated by economies of scale and consolidating some activities will have a positive effect on 1988 earnings. The on-going efforts to lower costs will continue to produce for Sterling wider gross margins and stronger earnings growth."

As a second point, Smith said that many of the transitional costs associated with the purchase will be part of the acquisition cost and will not show up on Kodak's or the consolidated company's books. The effect will be to limit the impact these costs will have on Kodak's 1988 earnings.

The third factor is the strength of both companies. He expressed confidence that Kodak's 1988 earnings will exceed analysts' current estimates "by some margin." And he also pointed out that many assumed that Kodak would be financing debt in the 10-percent to

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11 1/2-percent range.

"As you know," Smith said, "we began with a bridge loan through bank syndication to purchase Sterling's shares. This will be converted into both long-term and short-term fixed and variable rate debt, and, due to the value of the dollar, a reasonable portion may be financed outside the United States. As a result, we are looking at a long term rate under 9 percent."

Smith said the current estimate of the 1988 dilution is 15 to 25 cents per share.

Smith also addressed the issue of leverage, noting that the company's debt increase from 4 percent to almost 35 percent of total capitalization in the last decade has been the result of a conscious effort to increase the company's leverage.

"This is a very acceptable leverage level by virtually any measure and easily managed on Kodak's balance sheet," Smith said. "A major part of this leverage comes from long-term assets, receivables and inventory. The remainder is due to increased treasury stock generated through buy-backs beginning in 1984. As you can see, this is not the type of leverage that creates large risk."

While Kodak's leverage will be in excess of 50 percent for now, Smith said it is the company's intention, barring any unforeseen business changes, to return to roughly a 35-percent level by the end of 1993.

CONTACT -- Henry Kaska of Eastman Kodak, 716-724-4642, or Charles Smith of Eastman Pharmaceuticals, 215-640-8680, or John Wood of Sterling Drug, 212-907-3002, or Terry Kelley of Sterling Drug, 212-907-3009

LEVEL 3 - 17 OF 19 STORIES

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Business Week

February 22, 1988

SECTION: THE CORPORATION; Strategies; Pg. 134

LENGTH: 1149 words

HEADLINE: HAS KODAK SET ITSELF UP FOR A FALL?

BYLINE: By Leslie Helm in Rochester, with Susan Benway in New York

HIGHLIGHT:

Buying Sterling Drug could erase an impressive recovery

BODY:

Since Colby H. Chandler became chief executive of Eastman Kodak Co. in 1983, he has slashed costs, shaken up the bureaucracy, and plunged into new businesses. Today, Kodak is leaner, and its traditional photographic business is prospering. But Chandler's expensive forays into such areas as electronic publishing, batteries, optical memory, and floppy disks haven't paid off so far.

Now, Chandler is making his boldest move yet with the \$5.1 billion purchase of Sterling Drug Inc., the biggest takeover outside the oil industry in the past year. The purchase, in which Kodak outbid F. Hoffmann-La Roche & Co., culminates a long-standing effort to build a life sciences business based on Kodak's chemical expertise and on such diagnostic gear as blood analyzers. Kodak's drug efforts consisted mainly of dabbling with biotechnology joint ventures and licensing arrangements. But the Sterling purchase, says Chandler, makes Kodak a real drug industry player "with greater certainty, sooner, and at a better cost advantage." The hefty price tag, however, will dilute earnings through 1991. If not handled right, the merger could derail a recovery that has brought Kodak out of a six-year slump.

The recovery has been impressive. A management reorganization has helped loose a flood of new products. Chandler has stemmed the erosion by Fuji Photo Film to of Kodak's market share in film and paper. Profits tripled in 1987, to \$1.2 billion on \$13.3 billion in sales. To keep its momentum rolling, Kodak has recently announced some promising new products, including a color copier and a machine that allows people to make their own enlargements at photo shops.

The Sterling Drug deal, however, has tarnished the company's sheen on Wall Street. Kodak's stock has dropped 20%, to around 41. "They overpaid. They collapsed the stock," says John M. McCarthy, a partner at Lord, Abnett & Co., a money manager with a heavy stake in Kodak. Analysts are taking a dimmer view of Kodak's earnings. Peter J. Enderlin, of Smith Barney, Harris Upham & Co., has cut earnings projections for 1988 by 15%, to \$3.75 a share, though that still represents a 6% rise. One reason: higher interest costs, since financing the takeover will increase debt to 57% of capital from 35%.

Few quibble with Chandler's rationale for diversifying. Worldwide sales of traditional photographic film and paper, which bring in as much as 80% of Kodak's profits, are expected to slow as video cameras woo more customers. By 1991, Enderlin expects electronic products to grab 31% of the \$16.8 billion

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that will be spent on consumer photography annually in the U.S., up from 17% in 1986. As growth in the market for traditional products slows, Kodak may be forced to lower prices to hold on to its 50% share.

Aside from the price Kodak is paying, the nub of critics' concern is that the company has yet to inspire confidence that it can conceive, develop, and market new products that aren't closely related to its office-copier and traditional photography businesses. For instance, Kodak forked over \$175 million in 1985 for Verbatim Corp., a maker of floppy disks for computers. But Verbatim is barely profitable because Kodak has found it hard to cut costs enough to be competitive on price. Kodak also is struggling with a new information-storage system based on a 14-inch optical disk. A 12-inch disk has become the accepted format in the industry. "There is a difference between competing in a mature market [film] where you are dominant and in a leading-edge technology," says Scott C. McCreedy, an industry analyst at CAP International. "Kodak hasn't learned that."

VIDEO BUST. Kodak also struck out with its videocassette recorder and camera, which it recently yanked from stores after four years of slow sales. Again, it failed to deliver a competitive product. Another disappointment is a big-ticket electronic publishing system, complete with hardware, introduced in 1985. Big corporate customers are opting instead for software that runs on standard computers, such as Apple's Macintosh.

In 1986, Kodak began a much ballyhooed attempt to sell batteries, and once again the results are unimpressive. The company has been slow to leverage its distribution and brand name to take market share. Although an Olympics ad blitz may help boost sales, Kodak will be hard pressed to increase its market share above the current 10%, and it expects only minimal profits this year.

By acquiring Sterling, Kodak may already have passed upon one solution: It has considered buying Duracell, the No. 2 battery maker. But the \$1.5 billion price tag might be prohibitive now that Kodak must spend an additional \$300 million or so on interest annually.

It appears that Chandler has made a critical choice: Instead of spending 10 times earnings to buy a premier battery maker, he's paying 23 times earnings to buy a lackluster drug company. Sterling boasts such cash cows as Lysol and Bayer aspirin. But while other companies are pumping out a steady stream of innovative prescription drugs, Sterling has just one that tops \$100 million in sales.

'HANDSOME PRICE.' Kodak executives say it's too early to count out some of their struggling new products and say the experience in other fields is not necessarily a guide to what might happen in drugs. They are determined to use Kodak's background, international clout, and financial resources to help make Sterling a major player. "We a handsome price" for Sterling, says Kay R. Whitmore, the Kodak president to whom Sterling will report. "We have to make sure we can get a return for it." Sterling, which made \$197 million on \$2.3 billion in sales last year, will account for 15% of Kodak sales.

Executives Kodak has hired from such drug giants as Ciba-Geigy Corp. and Merck & Co. to direct Kodak's drug effort will be charged with redirecting Sterling's product development. But getting executives from other companies to harness Kodak and Sterling researchers together could be tough. "Research

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organizations have as much of an immune rejection system as the body," notes Norman C. Selby, a partner at McKinsey & Co. And Sterling has lost time to make up for. While it has stepped up spending on drug development in recent years, analysts see little in the pipeline to get excited about.

Still, there are some potential synergies. Sterling's highly regarded sales force could help Kodak sell its blood analyzers to hospitals. And Kodak may use its international operations to help Sterling sell such popular household products as Lysol in overseas markets. But for the price Chandler is paying, Kodak will need more than marketing efficiencies. It will have to introduce a host of fast-selling new products, too. Otherwise, the financial and management demands of Sterling may soon put the rest of Kodak out of focus.

GRAPHIC: Picture, CHANDLER: HIS EXPENSIVE FORAYS AWAY FROM PHOTOGRAPHY HAVE YET TO PAY OFF, PHOTOGRAPH BY PHIL MATT; Chart, HOW WALL STREET TURNED AGAINST KODAK, DATA: BRIDGE INFORMATION SYSTEMS INC. CHART BY LAUREL DAUNIS

LEVEL 3 - 18 OF 19 STORIES

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Los Angeles Times

January 25, 1988, Monday, Home Edition

SECTION: Business; Part 4; Page 2; Column 3; Financial Desk

LENGTH: 808 words

HEADLINE: KODAK SNAPS ITSELF OUT OF A TAILSPIN;
CHANGE IN CORPORATE CULTURE BRIGHTENS THE FILM GIANT'S FUTURE

BYLINE: By AP

DATELINE: ROCHESTER, N.Y.

BODY:

The walls tell it all at Eastman Kodak Co.

Historically, the company's sprawling manufacturing center, known as Kodak Park, has been painted in dull and conservative factory colors like gray or brown.

But a summer painting project produced bright flames on fire doors, murals in hallways, slogans and bright colors on cement walls, and pop art next to the soda machines.

In one control room, workers can scribble milestones on the heating ducts and the ceiling. The notations date back no farther than 1986.

"Before then, writing on the walls wasn't exactly considered the thing to do," said Ralph Olney, a unit manager in the film-sensitizing division, whose graffiti-prone staff works on a machine three football fields long that rolls out more than 300 feet of color film a minute.

Relaxation of Work Rules

The new decor is the most visible symbol of the radical changes that have given the 108-year-old photographic giant a new image and a new outlook. On Friday, the company took a major step in diversifying into the pharmaceutical industry by agreeing to purchase Sterling Drug for \$5.1 billion.

Gone are the days when suspicion and anxiety ruled, when employees were afraid to make suggestions and were told when to work an extra shift or when to cancel weekend plans because more work was needed.

Today, workers are urged to shut down massive production lines if they spot a problem. They're asked to work overtime. And they're given sophisticated statistics and information so they understand more of the big picture.

"I think what's different is that we're told more, so we know what's important and what it means to make a change," said Rick Ladue, a production worker in Kodak's paper support division.

@ 1988 Los Angeles Times, January 25, 1988

The changes have helped lead a turnaround for Kodak, which suffered six straight quarters of declining profits throughout 1985 and into 1986 before things started to pick up.

Through three quarters of 1987, Kodak's profits of \$936 million reached a record high, more than triple the same period in 1986, when they were \$299.4 million.

"I think what we've done is moved from a parent-child relationship to adult-adult and now people come to work excited about what they're able to do, excited about what they themselves can impact," said Ron Heidke, who's in charge of manufacturing film and paper at Kodak Park. There has never been a labor union at Kodak, partly because the company always paid top salaries and offered excellent benefits. Now the company is offering its employees something new -- the chance to speak up, Heidke said.

The transition is one that America's other large companies have either already started or must begin soon, said Colby Chandler, Kodak's chairman and chief executive.

"Kodak was quite representative of an old culture," Chandler said. "People seek the comfort level of groups. They tend to take the safe routes, rather than the ambitious and daring routes."

The change in corporate culture, along with a strict cost-cutting program and thousands of layoffs, have helped send Kodak's sales and profits soaring.

Chandler predicted that 1987 would prove to be a record year for sales and operating earnings when results are reported in February.

The success comes after two years that included the costly (\$494 million) and embarrassing court-ordered withdrawal from instant photography because of violations of Polaroid Corp. patents.

Analysts are pleased with the new Kodak, but not overwhelmed.

"The company's gotten some breaks," said Michael Ellmann, a Wertheim Schroeder & Co. analyst

What made the past year so good, Ellmann said, is the same thing that made previous years so bad -- things beyond the control of corporate management.

"I mean the dollar was so strong and just kept getting stronger, which just kept hurting Kodak," he said. "Now the dollar is weak and Kodak is getting a big break."

New Markets

Another break, according to Eugene Glazer, of Dean Witter Reynolds Inc.: a jump in the number of photos being taken.

"I think most everybody expected to see a 5% to 6% increase in the number of pictures taken and it's actually running closer to 10% this year," Glazer said.

@ 1988 Los Angeles Times, January 25, 1988

The new aggressiveness at Kodak is unmistakable. It is acquiring new businesses, jumping into joint ventures and discontinuing or swiftly introducing new products.

On Jan. 13, the company made an impressive entrance into the color copying market with a machine that is nearly four times faster than any other color copier. The company is also selling batteries and cameras made in Japan and is active in biotechnology.

The company's greatest challenge, Chandler said, is in keeping things from sliding backward.

"I'm not going to be satisfied until every individual in the company feels the need to be an individual contributor of ideas and judgment," Chandler said.

GRAPHIC: Photo, Kodak says "pit crews" formed recently to speed help to machines will cut costs at paper plant. Associated Press

TYPE: Wire

SUBJECT: EASTMAN KODAK INC; LABOR RELATIONS; CORPORATE RESTRUCTURING

LEVEL 3 - 19 OF 19 STORIES

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December 3, 1987, Thursday, BC cycle

SECTION: Financial Report.

LENGTH: 182 words

HEADLINE: KODAK <EK> SAYS IT WILL TO LAUNCH COLOR COPIER

DATELINE: CHICAGO, DEC 3

BODY:

Eastman Kodak Co expects to introduce shortly a color copier, chairman Colby Chandler said.

"An announcement in color copying from Kodak is imminent," Chandler said at a meeting with analysts.

He said he had told shareholders at the May annual meeting that Kodak will introduce the copier when "the time is right and the technology and marketplace are ready".

Chandler declined be more specific about timing of the introduction of the new copier.

He said Kodak field tested color copiers at selected sites during 1987.

In the 1988 first quarter, the company plans to introduce a Class 35 color printer for traditional laboratories.

Chandler said this will be the fastest printer in the world, printing 27,000 color prints an hour on a "burst" basis and 20,000 prints an hour on a continuous basis.

He said Kodak will have introduced 60 to 70 products during 1987 and 1988 looks equally promising.

Kodak's board will consider approval of a significant but reasonable increase in capital spending for 1988, Chandler said.

Expenditures in 1987 totaled about 1.7 billion dlrs.

Manufacturing tied to U.S. economic health

Kodak executive concerned about tax policies



Jim Laragy Democrat and Chronicle

Colby Chandler, Kodak chairman, is on a mission to alert people about how vital manufacturing is to the American economy. American manufacturing industry is not faring well, says Colby H. Chandler, who as chairman and chief executive of Eastman Kodak Co. heads one of the oldest and biggest U.S. manufacturing companies. Phil Ebersole, Democrat and Chronicle business reporter, talked to Chandler recently about the economy, job security and issues facing the U.S. manufacturing industry. An edited and condensed version of that talk follows.

How much time do you spend going around the country talking about manufacturing as an issue?

Since June I've probably talked to half a dozen audiences. It's about one every month on this subject.

If we let manufacturing continue to erode as a portion of our economy, the standard of living of the average American is going to erode right along with it. It seems to me that I have a responsibility to try to alert people to that.

Can you give your short list of the most urgent of our problems?

The most urgent is a basic philosophy of taxation which favors consumption and discourages saving. And I am using the word "saving" in its broadest sense — not just personal saving, but the difference between government spending and government revenues. Today we have negative savings at the federal level. And a very great deal of non-competitive American flows from that basic tax policy.

How does the savings rate affect Kodak?

Corporations in America, today, have (profit) margins that are depressed by about one half. They have balance sheets that are highly leveraged (with debt).

And that's not just due to acquisitions. To raise capital, they've had to do more borrowing. If their cost of capital is high, relative to our competitors, that is one of the reasons is that corporations are holding back. They don't have the cash flow. They don't want to go to the borrowing market.

That to me is the most dangerous economic sign we have today. In fact, maybe it's the only one that I am really concerned about. That is going to cause price increases, based on demand beyond (production) capacity. And that can be real inflationary. And that's very unfortunate.

Is the federal government borrowing crowding private corporations in the capital market?

Sure. That's one reason our cost of capital is off. The government is absorbing all of the borrowing from overseas, and corporations have to get in line.

The borrowing to cover our federal budget deficit comes in the form of the negative trade balance. The way we are going to have to fix that, long term, is to run a trade surplus.

And if we're going to do that, we're going to have to do that with manufacturing, because 80-plus percent of all of the trade is manufactured goods.

Do you feel that the dollar is still overvalued?

Yes. It's 20 percent overvalued today and, at the rate things are going, it will have to go down to 80 yen to the dollar in five years.

What do you think of the idea of a value-added tax?

A straight value-added tax applied to everything 'across the board' would be unfair to the poor and would be regressive. That would be true. But a value-added tax does not have to be those things and it doesn't have to be an elegant concoction of complexity to avoid those things.

I think a value-added tax is fundamentally sound. It taxes consumption rather than investment and savings.

I do think, however, that the value-added tax should be a substitute for something else. Now Ronald Reagan ran into his first buzzsaw — where was he? in New Hampshire? — when he said we ought to abolish the corporate income tax.

Conceptually, he is right, but how do you convince the public? The problem with the corporate business tax is that it's a pass-through. Society pays that tax. Business isn't a source of wealth. Business is a conduit.

Is there anything that local political leaders and local business leaders can do to promote manufacturing in the Rochester area?

NTINUATION

The most important thing that could be done, and this is theoretical, is for the Annett press to present a factual view of manufacturing in Rochester.

I think that there is a terrible misunderstanding of what goes on in corporations. What the motives are in corporations. What they have to do to be successful in the world.

I imagine the average person in Rochester doesn't realize that corporations are dealing with the question of survival essentially every day of their lives. Was it someone that wrote a letter to the newspaper this week that said "The God Kodak had to decide..."

People have images that we have somehow behaved as though we were omnipotent and have all these choices of things to do. In fact, hour by hour, our activities are as though we were on a survival course because the forces are all there to drive you out of existence.

Now why did I answer you like I did? Why would that change us in Rochester if everybody in Rochester had a better appreciation? Well, for one thing, I'd like to see changed expectations in the minds of all of the constituencies, people who apply for work, people who try to sell their goods and services to the company, and that they understand that what a corporation really is, that a corporation is a pass-through.

Things come in and things go out. Goods, materials come in and products go out. Money comes in from customers, dividends go out. They somehow think a corporation is a great big thing like a well in the ground, and the money comes up out of the well.

What does the public — taking the people who live in the Rand Street area as an example — have a right to expect from Kodak and what is it not reasonable for them or anyone else to expect from Kodak?

They have a right to expect that we'll be good corporate citizens. We will conduct our affairs in a way that will not harm them and that we will be fair if they're employees, fair to them and equitable, and help them grow.

I think they don't have a right to continually believe and attribute motives that are outlandishly ridiculous. I think we're in that situation today.

So what you ask is for people to believe that you are acting in good faith.

Yes. We assume others are acting in good faith, but I don't think that it's reciprocated.

It's an enormous burden to carry. I'm seeing it in our management people. It's dragging them down.

I surely am not asking for cheerleaders. But I would ask for objectivity.

Now you could ask your question all over again and say, "OK, that's what you say Rochester could do to help. How big a factor is that?" And I would say it's not a make or break factor.

So then the make or break things do not happen on a local level?

The thing on the local level which is so important to the company is the quality of the work force. And to some extent we are responsible for that. That's one other

expect from us — that we will do everything that we can to enhance the quality of the work force.

And we've done that, but every day that goes by, we get better at it. I've said many times in public that I don't think there's time for any government agency to, by itself, solve the education problem in America from the point of view of industrial usage of people.

It's a matter of expectations. There are people — starting back in the 1960s — who have expectations of earning and career out of proportion to expectations for work. I think that's turned around. We have a lot of people coming in now that come in with expectations to work.

But that's an awfully important thing to a corporation — how people view their job. Did they really ask for work when they came in the door? Or did they ask for compensation?

We're coming into a period where fewer young people will be entering the work force. How is Kodak going to respond to that?

I think that it will be a dramatic effect on a company like Kodak.

Turnover will increase. Three percent turnover is sort of a base statistic that not only applies to Kodak but applies to any mature work force. It is the rate at which people become eligible for retirement.

The demand for freshly trained specialists is going to be so great that the lateral movement of people across companies is going to increase. To get jobs done, people are going to take jobs in retirement, and, of course, the women in the work forces will go higher.

One of the things that will happen at the same time is a clear trend toward employment security. I'll use that expression. Other terms that are somewhat like it are job security, lifetime employment.

But the term employment security is one that I think conceptually is worth working toward. That means that once a person has begun to put a number of years with a corporation, the corporation has an obligation to that individual, because they become less qualified to work somewhere else.

Through a 40-year career of an employee today, obsolescence in most jobs is less than 10 years. So we're already at a point where a person has to change their career path, maybe in five different steps.

If you have a policy that says you're going to do something with them, cross-company movements could be managed. That's one thing they do in Japan very nicely. But we're going to have to find ways of taking people from one stage of a career and then training them to move over into another kind of work.

I couldn't go back and practice engineering. I'd be a total failure.

We made a big deal here a few years ago about retraining a lot of our people from general kinds of engineering into computer science. We're doing a lot of that now. We're going to have to do much, much more.

About 2 percent of our jobs are unskilled. About 5 percent of the people we hire, who are intelligent people, are illiterate to the extent that they are not safe in

a manufacturing environment. Here's another 10 percent who are not high school equivalent.

We in industry can't delegate that problem or slop it off to someone else. We've got to take responsibility for dealing with the problem. Otherwise the risk is too great that it will not be met adequately. And so what we need to do is employ the universities, the junior colleges, et cetera, to help us, but that we better stay in charge of it.

Fifteen years ago, it was generally accepted that if you once got a job at Kodak and you made an effort to do a good job, you could count on working for Kodak for life. Many people were disappointed in that expectation in the early 1980s. What I infer from what you're saying is that with its smaller work force, Kodak is going to try to return to that.

Absolutely. That's what people did then. They'd start and they might actually end up working 40 years doing almost exactly the same thing. There's no hope of that being the case. Even with the unskilled, you can't expect this.

But there are lots of reasons I say what I've said, which is a yes to your question. I think from a pragmatic point of view we need to try to return to that kind of situation.

And also the word you used — if they stay on the job and do a good job, or something like that. You'd find supervisors and others saying "What if they're not doing a good job?" And somewhere the company can't afford to keep paying people who are not doing a good job.

The premise I put in here is that we continue to do a good job in selection and hiring. Therefore when you run into performance gaps on the job, the first place you look is "What have we done as a corporation to bring that about? Have we misplaced a person?" Which is the most likely possibility.

I've seen so many cases where a person could be taken out of a job where they are not performing at all, they just suddenly catch fire when they are doing something they like to do.

And this philosophy that you referred to as something to return to — I agree. Employment security. This philosophy puts the pressure where it should be, and that is "Do I have the person in the right job, have I provided the right tools?" And I think that Kodak management accept that kind of a challenge.

The only thing that can override it, of course, is bad times. What do you do in bad times? Hopefully, if you plan well and have enough different sectors of the company, you can swing with that.

Kodak chairman spreads gospel of manufacturing

By Randolph Picht

ASSOCIATED PRESS

ROCHESTER, N.Y. — Colby Chandler, chairman and chief executive officer of Eastman Kodak Co., has spent 38 years learning the lessons of business, the theories of economics and the inside-out story of the world's largest photography company.

Now, after five years at the helm of Kodak, Chandler is ready to take his message on the future of manufacturing to the masses.

So move over, Lee Iacocca, because here comes Colby "America won't make it without manufacturing" Chandler.

At 63, the low-key engineer, who grew up and still lives on a farm, is learning how to become a stand-up spokesman for corporate America. If it sounds political, it is.

"Watching the swing toward a service-intensive society and listening to some parties say that's good is scary," said Chandler in an interview at Kodak's headquarters in Rochester.

"I have no intention of talking to the walls on this subject."

Kodak's chief has been out preaching the manufacturing gospel to business groups, college students, politicians and anybody else who will listen. The company also commissioned a study by three leading economists on the importance of manufacturing and started its first public affairs advertising campaign on the issue.

Chandler also is using his last few weeks as chairman of President Reagan's Export Council, the chief advisory group to the Department of Commerce, to drum up support.

"The importance of manufacturing to the economy has been something that's been so obvious to me, and I'm sure to others like me, that it might not have ever occurred to us that it wasn't obvious to everyone else," he said.

Although leaders of service industries might disagree, Chandler claims that one job making a car, a copier or a computer is 10 times more valuable to the economy than a selling insurance, waiting on customers in a bank or making airline reservations.

The percentage of workers employed in manufacturing in America — 20 percent of the work force — is lower than at any time this century, according to the Kodak-commissioned study "The Case For Manufacturing in America's Future."

What that means, Chandler said, is that the large "multiplier effect" manufacturing has in stimulating the economy through higher wages, buying supplies and raw materials, as well as creating new and improved products, is drying up.

"It's a very critical ... edge that we walk," Chandler said.

"We're not the country with

leading productivity gains. That's a sign. When we reach the real crisis, we will have gone so far that bringing it back is going to take decades and decades."

The best way to help manufacturing in the immediate future would be to eliminate the federal deficit, Chandler said. But for the long-term, he suggested:

- Urging the government to make education and other people-oriented benefits a priority.

- Using spending and tax policies to encourage investment in new technology and research.

- Implementing an incremental investment tax credit that would provide incentives for companies to expand a plant or buy new equipment.

- Altering the nation's tax structure to put a higher emphasis on taxing consumption rather than the current system of taxing investment and saving.

Chandler has always had a reputation on Wall Street as "Mr. Long-Term," even before he took over as chairman of Kodak.

He came to the company in 1950 after graduating from the University of Maine with a physics degree. He worked as a quality control engineer and then held various management positions.

He received a master's degree in management from Massachusetts Institute of Technology in 1964 and directed the development of Kodak's Ektaprint copiers and duplicators in 1973. He was appointed president of the company in 1977 and chairman in 1983.

CONTINUED

CONTINUATION

As chairman, Chandler has sent the yellow Kodak banner charging into Japan and given assembly-line workers almost complete control over film and other products they make.

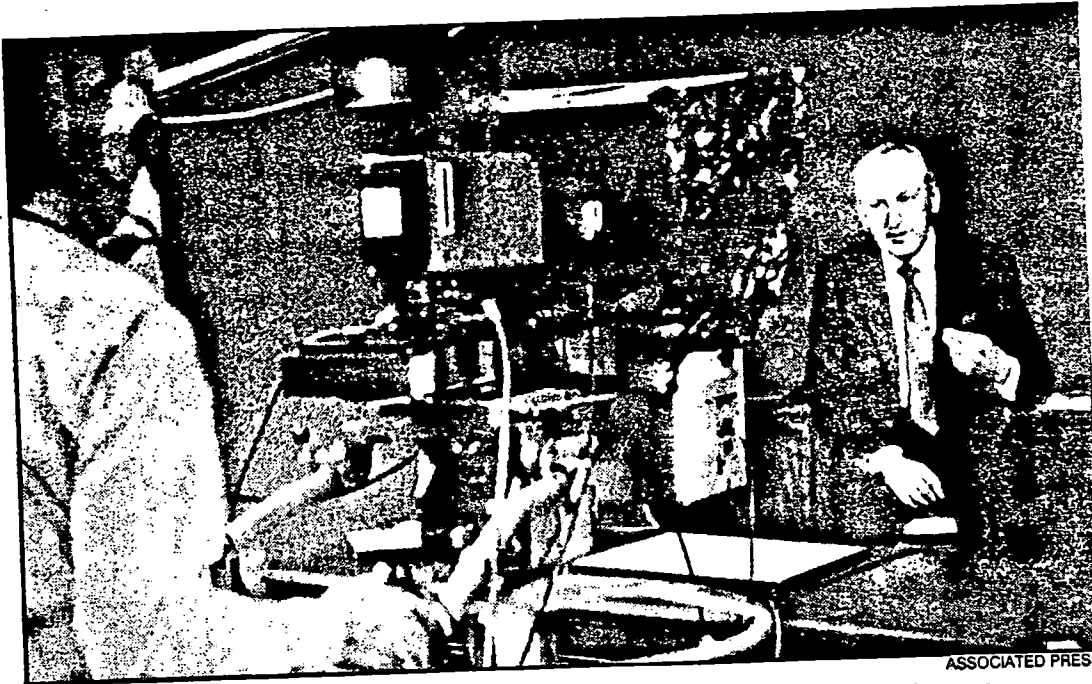
And he's added aspirins, batteries and household cleaners to the list of products Kodak sells through new ventures and the acquisition of Sterling Drug Co.

"He never seemed as concerned with the nuts and bolts stuff of today or tomorrow. What interested him was Kodak three, five, 10, 20 years from now," said Brian Fernandez, a stock analyst with Brean Murray, Foster Securities.

When Chandler started Kodak's restructuring effort several years ago to cut out layers of management and give each employee more responsibility, Chandler said he restructured his job to include a more active role in outside affairs that affect the company.

Unfortunately, it appears that no one seems to care about the eroding manufacturing base of the country, especially the politicians, Chandler said.

"They're patching up problems, they're responding to special interests, and there's very little sitting back in a statesman-like way saying, 'Where do we want to lead this country?'" he said. "You perhaps could make an observation that they can't. My feeling is they must."



ASSOCIATED PRESS

Colby Chandler records his message in studio at Kodak's headquarters.

Study of Manufacturers' Problems Part of Campaign to Spark Debate

By John M. Berry
Washington Post Staff Writer

Colby H. Chandler, chairman of Eastman Kodak Co., yesterday set out to provoke a debate about the economic perils facing the nation—a debate he says the presidential candidates are ducking.

At a Capitol Hill press conference, Chandler released a study, written by three highly regarded economists, that says the nation's manufacturers remain in serious trouble despite a recent glow of apparent health.

Chandler, who also is chairman of the President's Export Council, an advisory group, said the absence of serious discussion about America's economic future leaves him with a "sense of frustration and deep concern."

"As a nation, we sit upon an economic house of cards," he said. "What is needed is a national debate on the future direction of economic policy that is both realistic and responsible. Yet, I hear little . . ."

The debate he seeks would test the strongest political backbone. As part of a plan to reduce federal budget deficits, Chandler called for, among other things, taxation of half of Social Security benefits; higher taxes on cigarettes and distilled spirits; a gasoline tax of 10 cents a gallon; taxation of portfolio income earned in the United States by foreigners; tighter enforcement of the tax laws; and consideration of a new value-added tax.

And in urging new steps to slash the nation's large merchandise trade deficit, Chandler said that "efforts to stabilize U.S. exchange rates at current levels would be misguided and risk a serious recession." The Reagan administration has agreed with other industrial nations to attempt such a stabiliza-

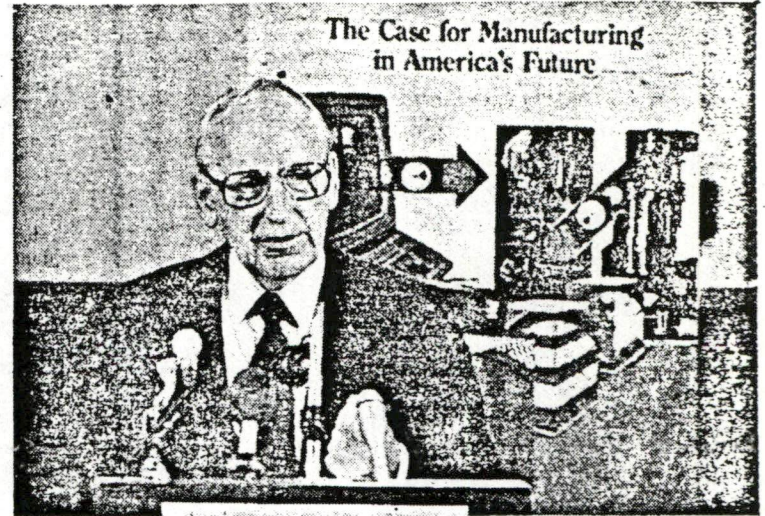
tion. The proposals were among the recommendations of a study commissioned by Kodak—actually more a commentary than a study—written by economists Lawrence H. Summers of Harvard University and Rudiger W. Dornbusch and James Poterba of Massachusetts Institute of Technology.

Chandler said he had sent a letter to each of the Republican and Democratic presidential candidates noting the study's conclusions and asking, "As a leading American manufacturer, I would like to know more about your plans to maintain a strong manufacturing sector and a healthy U.S. economy. I am very concerned that thus far in the presidential campaign these issues are not being addressed in a serious and comprehensive manner."

The letter continued: "Manufacturing is doing relatively well right now because many companies have taken the necessary steps of restructuring and retooling to be world class competitors, and because the dollar has fallen. However, the current situation must be viewed as very fragile.

"What guarantee do manufacturers have that the dollar will not skyrocket again because interest rates must go up to keep foreign money flowing into the U.S.? How do we avoid a deep recession or inflation, or both sometime in the next year? What assurance do we have that another October 19 stock market crash will not happen tomorrow?"

"These are all real possibilities that pose real risks to manufacturing and, indeed, the whole economy," Chandler's letter said. "They are serious threats because we have failed to tackle the underlying problems that afflict this economy; namely, a massive budget deficit coupled with very low national savings. The result of this unfortunate combination is that we keep borrowing huge amounts



Kodak Chairman Colby H. Chandler says a realistic debate on U.S. economic policy is needed.

from abroad, our external debt keeps rising, and our vulnerability to shocks keeps mounting.

"We are now half way through the presidential campaign. Yet, none of the remaining candidates are even talking about these problems, let alone offering solutions. Instead, we get promises of new spending programs, and pledges of no tax increases. The country faces painful choices and difficult adjustments. But that is not apparent from listening to the candidates for president of the United States."

So far, Chandler has had no reply to his unusual letter from any of the candidates.

Most of the points made in the study, "The Case for Manufacturing in America's Future," are not new. Nevertheless, taken together they buttress the argument that manufacturing in the United States has borne the brunt of the impact of the economic policies

chosen by the federal government in recent years.

A low level of national savings—exacerbated by large federal budget deficits—has reduced the supply of capital and hurt investment, the economists said. Such a low savings rate has forced the United States to borrow from abroad to finance a substantial portion of the investment that has occurred.

"This makes trade deficits inevitable," they said, adding, "The composition of U.S. trade implies that a large part of the burden from a rising trade deficit falls on manufacturing industries."

But some actions that would increase the deficit are necessary, too, they said. One of the actions, a partial restoration of the 15 percent tax credit on investments in business equipment that was repealed in the 1986 tax overhaul, would cost about \$10 billion a year.

See MANUFACTURE, G3, Col. 4

Study Aimed At Sparking Economic Debate

MANUFACTURE, From G1

Chandler and the economists also argued strongly that the value of the dollar will have to fall farther if the trade deficit is to be eliminated without plunging the nation into a recession.

"Monetary policies directed at maintaining exchange rates near current levels would be catastrophic for the manufacturing sector," the study said. "In addition to reducing foreign demand for U.S. products and increasing American demand for foreign products, tight monetary policies in defense of the exchange rate would raise interest rates and the risk of a recession. Postponing the inevitable exchange rate adjustment only magnifies the ultimate distress."

One of the authors, Summers,

conceded that manufacturing's share of the economy has not declined. However, he said, "The concern is not just whether we can sell products but at what price."

Manufacturing has been able to maintain its share of output only by pushing down real factory wages and accepting lower profitability. A healthy manufacturing sector, Summers said, would be one in which

"As a nation, we sit upon an economic house of cards."

— Colby H. Chandler
Eastman Kodak Co. chairman

growth of the standard of living was comparable to that in other industrial countries—as opposed to one in which real wages and profits are falling.

The candidates' responses should be interesting—if they arrive.

BUSINESS

Kodak's chief sparks debate on peril facing U.S. economy



Chandler

Chandler exhorts candidates

By Phil Ebersole

Democrat and Chronicle

Colby H. Chandler, chairman and chief executive officer of Eastman Kodak Co., yesterday called on the presidential candidates to get serious about the nation's economy and its troubled manufacturing industries.

He also made public a study by three professional economists, commissioned by Kodak, which concludes that the United States sits upon "an economic house of cards."

Chandler said he's sent letters to each of the candidates asking them to outline their economic plans in detail — something none of them has done yet, he said.

"The next president of the United States will be presented with a painful choice," he said.

"Swallow the bitter medicine of budget cuts, tax increases and structural tax reforms . . . or accept recession, global economic retreat and a lower standard of living."

The study, "The Case for Manufacturing in America's Future," makes several proposals which themselves may lower the living standards of ordinary Americans.

These include taxes on consumption, a cheaper U.S. dollar and cuts in federal domestic programs, possibly including Social Security.

But such measures are needed to preserve manufacturing industry. "Growth in our manufacturing sector translates into more high-wage jobs and a higher standard of living for all of us," Chandler said.



C. Chandler

The study was done by Rudiger Dornbusch and James Poterba of Massachusetts Institute of Technology and Lawrence Summers of Harvard University.

Chandler, in a press conference at the Russell Senate Office Building in Washington, D.C., said the study, which he largely agrees with, underlines the importance of manufacturing.

Although manufacturing provides less than 20 percent of U.S. jobs, it produces more than 60 percent of U.S. wealth and performs 95 percent of private research and development.

But American manufacturing is in trouble, Chandler said.

U.S. trade volume has grown only 2.7 percent a year since 1968, compared with 4.4 percent for other industrial nations and 7.9 percent for Japan. U.S. gains in productivity have been less than other countries, and, in recent years, only about half the gains made by Japan.

"It is true we in manufacturing are doing better" in the past few years, he said, but that's due largely to the decline in the U.S. dollar exchange rate and the largest peacetime military buildup in history.

The balance of trade in manufactured goods has gone from a \$17 billion surplus in 1980 to a \$170 billion deficit in 1987, net national savings have declined from 7 percent in the 1970s to 3 percent in the 1980s and the federal budget deficit is triple what it was in 1980.

To balance the budget, the study concludes, not even Social Security should be considered exempt from budget cuts. "I know such cuts would be extremely controversial," Chandler acknowledged.

He said the study advocates new taxes, which should be on

consumption rather than on savings and investment. One possibility is a value-added tax; a value-added tax is like a sales tax, but it's imposed at all stages of production, not just sales to consumers, and it's rebated on exported goods.

Any investment credits should be for new plants and equipment, not replacements, he said.

The study opposes U.S. barriers against imports, but says the federal government should act to break down foreign barriers to U.S. products.

Kodak spokesmen didn't know whether Chandler will make public the candidates' replies.

They said only a limited number of copies of the study are on hand. They'll announce later whether and how people can send for copies.

BUSINESS

HOBART ROWEN

Facing the Challenge Ahead

Except for died-in-the-wool Reaganites, the current assumption is that the U.S. economy faces a staggering set of problems over the next decade, and that it will be the unenviable task of the new president—Republican or Democrat—to begin unwinding some of the mistakes of the past eight years.

"The economy increasingly is resting on the shifting sands of debt," Sen. Paul Sarbanes (D-Md.) said at a press conference in conjunction with the annual report of his Joint Economic Committee (JEC).

Coincidentally, Chairman Colby H. Chandler of the Eastman Kodak Co., in releasing a new study that focuses on the special problems of manufacturers, said that the United States sits on "an economic house of cards." And he chided all the presidential candidates for failing

to come up with detailed plans for dealing with the problems.

Of course, Vice President George Bush doesn't concede that there is a

The current assumption is that the economy faces staggering problems.

major economic problem, instead hailing the great advances made under Reagan. And the JEC's minority report, contesting Sarbanes' account as "gloom and

See ROWEN, H8, Col. 1

Facing the Economic Challenge Ahead

ROWEN, From H1

doom," said: "Never has the foundation of our economy been stronger."

But the point made by Sarbanes and the majority of the joint committee is that Reaganomics has left "a legacy of sharp imbalances—imbalances that cannot be sustained."

Sarbanes is talking about a half-dozen key areas—especially debt, where the trend lines have taken an unprecedented turn for the worse: business, consumer, Third World, and U.S. government debt all have piled up to unbelievable heights.

For example, the study commissioned by Kodak—by economists Rudiger Dornbusch, James Poterba and Lawrence Summers—observes that the federal government now pays \$586 million a day to service its debt, or more last year than the aggregate earnings of most big corporations.

The JEC's Democrats also are troubled that real hourly compensation paid to workers (including fringe benefits) have not risen in this decade. In part, this is a result of the "hit" that American rust-bucket industries had to take when their performance proved to be noncompetitive with imports. (In part, the failure of compensation to keep pace with productivity also implies weaker union power.)

But Sarbanes and his Democratic colleagues on the JEC are caught in a political dilemma: They can neatly define the problems, and even suggest the solutions in a general way—reduce the deficits, be more adventurous on Third World debt, do better on trade, stress economic growth. But they can't be precise, because a tax increase is a necessary element.

Chandler, as a businessman, is more candid: "The next president of the United States will be presented with a painful choice: swallow the bitter medicine of budget cuts, tax increases, and structural tax reforms to begin to cure our root economic maladies and strengthen America's



BY JAMES K.W. ATHERTON—THE WASHINGTON POST

Rep. Chalmers Wylie, left, and Sen. Paul Sarbanes present JEC report.

manufacturing sector; or accept recession, global economic retreat and a lower standard of living. Sadly, in the campaign of 1988, competitiveness remains a buzzword, rather than a serious national goal."

The Dornbusch-Poterba-Summers recommendations include a new look at the Tax Reform Act of 1986, which they say was "a step backwards" in promoting savings and investment. They also would abandon the Reagan administration's "misguided" effort to hold the dollar steady at current levels. "Policymakers should recognize that a continued dollar decline is both likely and desirable," they say.

In grappling with the dilemma of how to reshape economic policy, the newly elected president might gain political "cover" by relying on a study now in progress by the new National Economic Commission (NEC), cochaired by Democrat Robert Strauss and Republican Drew Lewis.

George Bush has already indicated he would give short shrift to the NEC, fearing it is geared to recommending a major tax increase. An aide to Michael Dukakis, in response to my question on how the Massachusetts governor will deal with the Strauss-Lewis group, said: "He endorsed the creation of the commission last October, but he doesn't believe it can be a

substitute for effective presidential leadership."

The Dukakis aide said that the NEC, scheduled to report in March 1989, will be late in dealing with the problem. Bush or Dukakis would appoint two new members to the commission after the election, and could alter the timetable. But each, clearly, wants to make no commitments in advance.

In his campaign speeches, Dukakis promises a "one hundred days" crash economic program to "build a brighter economic future." It's too early to get a sense of what will be involved. But if Dukakis is elected, my hunch is that some of the elements of the Dornbusch-Poterba-Summers program may appeal to him.

He's unlikely to confront the deficit problem head-on with a big tax increase all at once, but rather would try to sell a multiyear deficit-reduction program to Congress and private leaders in business and labor—recognizing the strong links between domestic and international economic-policy goals.

As for Bush, he'll face the same grim reality as would Dukakis—and ultimately will have to take many of the same steps, including tax increases. Either Bush or Dukakis will have only a short window of opportunity in which to act. If they don't, the legacy of voodoo economics could accelerate the process of declining American power in world affairs.

William Raspberry

Who Says We're Post-Industrial?

Post-industrial America is moving from a manufacturing to a service-based economy.

Say it often enough, with enough matter-of-fact certitude, and it starts to sound as unchallengeable as the announcement that your teen-age son is moving from adolescence to adulthood—that is to say, both inevitable and desirable.

Well, Colby H. Chandler says it's neither, and the chairman and chief executive officer of Eastman Kodak Co. has commissioned a scholarly study to prove the point. He was down from his Rochester headquarters last Friday to release the results of that study: "The Case for Manufacturing in America's Future."

"To begin with," he told me in an interview prior to his Capitol Hill press conference, "we should not be viewing ourselves as post-industrial. Certainly our trading partners aren't viewing themselves that way, and we're losing our export market—80 percent of it in manufactured goods—to them.

"I have no quarrel with the service sector, but I think we need a balance in the world economy. For us to shift to a service economy, which has a significantly lower wage structure than the manufacturing sector, while our competitors are becoming more industrial lowers our standard of living. We are becoming a market for foreign goods."

But isn't that because Americans are turning out shoddy products while our competitors in Europe and the Far East are focusing on quality?

Not entirely, says Chandler. He won't deny that product quality has had its effect on American manufacturers, but he insists that the quality gap has narrowed significantly in recent

years, and, in any case, deteriorating quality is just one of the things that has gone wrong.

The principal culprit, he says, is the failed "experiment" of the early 1980s—the fiscal and monetary policies that produced America's trade and budget deficits, largely by overvaluing the dollar.

"We knowingly watched this happen. All of us had a chance to scream, but business didn't begin to complain until 1984. Academia didn't complain. Economic journalists didn't complain. The assumption was that strong is good."

But when it comes to the overvalued dollar, he says, it turns out that strong is terrible.

Item. The federal debt is three times larger today than it was in 1980, and the debt service alone—some \$586 million a day—is costing the U.S. Treasury more every three days than Kodak, one of the top 10 firms in the country, earned in all of 1987.

Item. Our net savings rate has declined from 7 percent in the '70s to only 2 percent today—half of the British rate, a fifth of the rate in France and Germany, and a mere eighth of the Japanese rate.

Item. The U.S. trade balance in manufactured goods has "collapsed" in the 1980s from a \$17 billion surplus to a deficit of \$170 billion last year, including a first-ever deficit in high-tech goods.

Item. America in the 1980s has lost 1.2 million manufacturing jobs—2 million if you count from the peak levels of 1979.

Chandler says we have failed to grasp what the Kodak-commissioned study makes clear: that there are hidden costs in the shift from manufacturing to service. Manufacturing may account for only 20 percent of the gross domes-

tic product, but its purchases from other firms represent more than a third of the gross domestic product, and its shipments account for nearly 60 percent of the gross domestic product.

Moreover, a key source of economic growth is improved productivity resulting from research and development. The manufacturing sector, while accounting for only a fifth of the gross domestic product in 1984, was responsible for more than 96 percent of all R&D expenditures. And finally, unlike the service sector, every manufacturing job creates three other jobs in the economy.

As a result of all these factors, says Chandler, the decline in manufacturing has turned the U.S. economy into "a house of cards" that threatens to topple if something isn't done soon.

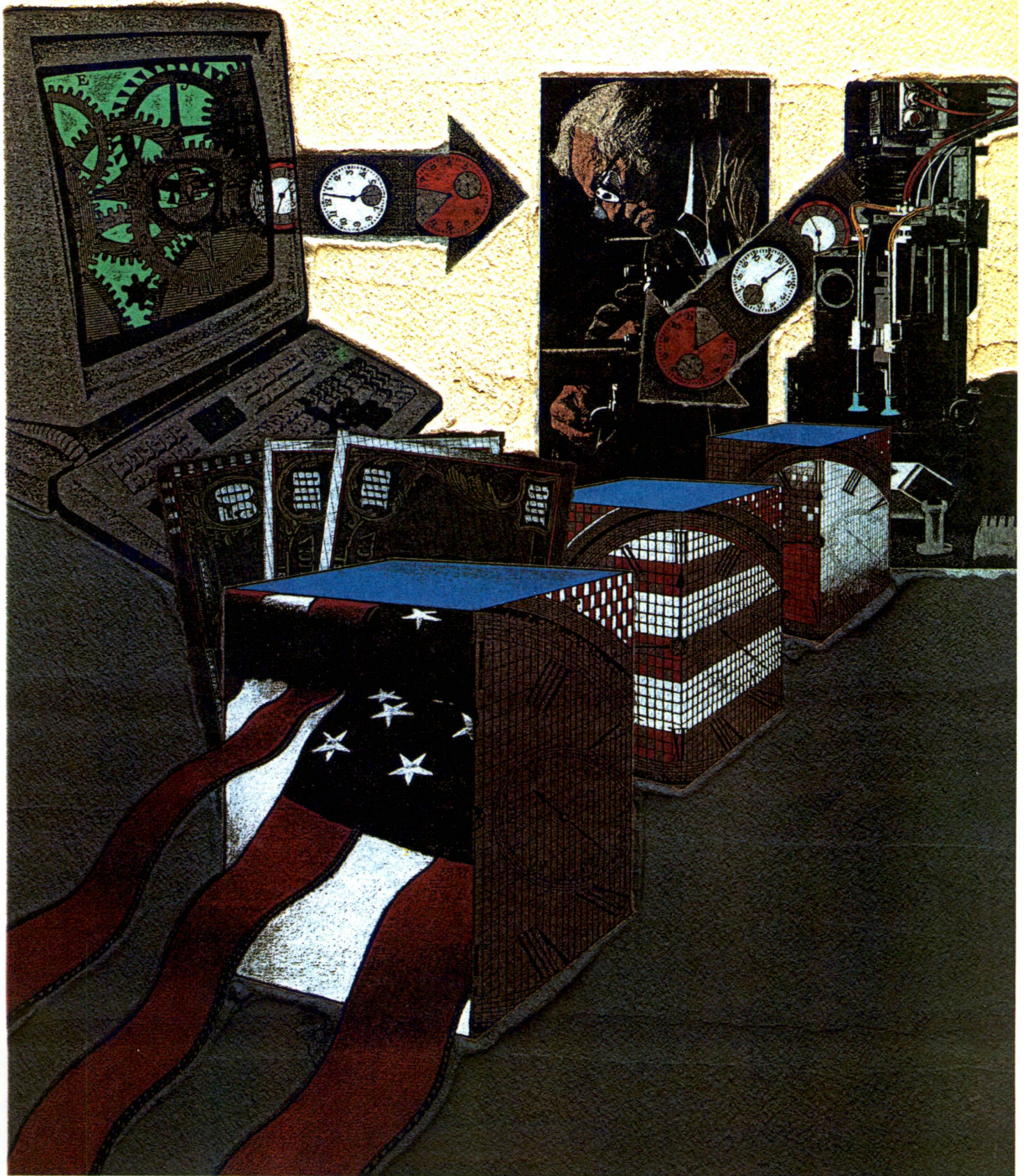
And what should be done? The overriding need, says Chandler, is to reduce the federal deficit by reducing expenditures, even in such sacrosanct areas as defense and Social Security, and by increasing revenues.

"As far as raising taxes is concerned, I try to be careful to talk about it in terms of tax structure. We talk an awful lot about tax reform. One of these days we ought to do it. All we've done so far is fool around with the rates. We still encourage consumption and discourage savings and investment."

Chandler and the authors of his new study have some ideas as to how to restore American manufacturing to its place in the world economy. But for now, he'd be content to trigger a serious national debate on the subject.

"Right now, nobody's talking about it very much: not business, not academia, not our elected officials, and not the people in your business."

The Case for Manufacturing in America's Future



The Case for Manufacturing in America's Future

by

Rudiger Dornbusch

James Poterba

Lawrence Summers

with a foreword by

Colby H. Chandler

1988



Colby H. Chandler

Chairman and Chief Executive Officer
Eastman Kodak Company

In the first half of the decade, the United States conducted an experiment in national economic

policy which brought both great benefit and great harm to the U.S. economy. Inflation, which seemed out of control in the 1970's, was tamed, and we have experienced the longest peacetime economic expansion in the postwar period.

These gains, however, were achieved at substantial cost, since we have run the largest budget and trade deficits in our history. These deficits fundamentally altered America's position in the world. Where we were its largest creditor, we are now dependent on foreign financing and are its largest debtor.

At the time these policies were being implemented, American manufacturers failed to fully appreciate how they would affect our ability to do business at home and abroad. Indeed, the toll has been very high. Domestic and world markets, which traditionally were ours, were ceded to others as our competitiveness plummeted due in large measure to an overvalued dollar.

To be sure, there was a silver lining in this very difficult period for many of us. It forced manufacturers to make substantial internal adjustments, adjustments which in many cases needed to be made and for too long had been delayed.

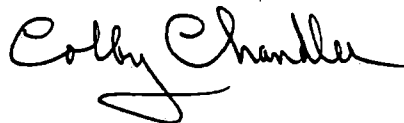
It is my sense that we learned a very important lesson: namely, we cannot afford to be complacent. There always will be more that needs to be done to improve the quality of our products and cut costs if we are to remain on top in an intensely competitive world marketplace. In a very real sense, change and the resulting need to adjust have accelerated exponentially beyond the pace of the 1950's, 1960's or even the 1970's.

We also learned another lesson during these years: that manufacturing has a critical stake in the conduct of national economic policy. Even if we make top-quality products at low cost, it is difficult to be competitive if policies at the national level result in massive domestic and external deficits.

With this lesson in mind, we engaged in an effort to learn more about the importance of manufacturing to the overall economy, and the effect of economic policy on the prospects for this sector. The present study, "The Case for Manufacturing in America's Future" results from this undertaking. It documents that a strong manufacturing sector is essential to the health of the overall economy and our future standard of living. It also shows that, relative to manufacturing in other industrial countries, U.S. manufacturing is not faring well and could be doing better if appropriate policies were in place.

We believe that the policy debate on economic choices will be improved if a manufacturing perspective is presented in a coherent, sensible and readable fashion. It is in this light that I urge a careful review of this report. It is meant to stimulate thought and discussion.

I enjoyed participating in discussions in the preparation of this project and I personally support the broad thrust of its policy recommendations. Others might disagree. But we need an informed and thoughtful debate in this country about the direction of economic policy over the next several years. We face very hard choices and difficult adjustments. This report should add to this essential debate.



EXECUTIVE SUMMARY

This report examines the competitiveness of American manufacturing and its relation to national economic policies. It begins by highlighting the crucial role of manufacturing in the American economy, and examining the recent performance of the U.S. manufacturing sector. We find that:

- The economic importance of manufacturing is disproportionate to its relative share in the economy. While manufacturing contributes one fifth of national output, it does more than ninety-five percent of private research and development. It is an important provider of high-wage jobs and a major source of product demand for other sectors.
- Manufacturing firms bear the brunt of cyclical fluctuations and macroeconomic policies that generate substantial trade imbalances. Virtually all of the swing in the overall U.S. balance of trade between 1979 and 1985 is accounted for by movements in manufacturing trade. Manufacturing employment has contracted throughout the 1980s as (at least until very recently) both domestic and world markets have increasingly been ceded to foreign competitors.
- In Japan and in all non-U.S. OECD countries as a group, manufacturing is growing more rapidly than total output and the importance of manufacturing in economic activity is therefore rising. In the U.S., by contrast, manufacturing is at best constant or even declining if we look at the 1979-1985 period. By international standards the U.S. is experiencing both low absolute and low relative growth in manufacturing. Our share in world trade has been falling, and import penetration in our own market has increased dramatically.

We believe that the primary reason for the failure of American manufacturers is national economic policies that have given rise to huge twin trade and budget deficits, favored consumption over saving and investment, and been insufficiently sensitive to the need for free markets both at home and abroad. We offer policy recommendations directed at each of these areas:

Fiscal Policy

- Bringing Federal budget deficits under control should be the overriding priority of national economic policy. Reduced budget deficits and increased national saving is essential if American competitiveness problems are to be resolved. This will require consideration of spending cuts in previously sacrosanct budget areas, including Social Security, as well as a significant increase in Federal tax collections. In the short run, various excise taxes could generate significant increases in Federal revenues, but for the long run, serious consideration should be given to new national consumption taxes.
- Structural tax policies should be redirected towards the goals of promoting saving and investment rather than consumption. From this perspective, the 1986 Tax Reform Act was in important respects a step backwards. Serious consideration should be given to restoring the investment tax credit, perhaps on an incremental basis. A crucial long run policy priority is finding ways of raising anemic American private saving rates.

Structural Trade Policies

- The newly industrialized countries pose a significant and increasing challenge to American manufacturers. Efforts to thwart the entry of their products into the United States are not likely to succeed, and if they did succeed would impose large costs on American consumers. Instead of seeking to block imports American policy should concentrate on opening up markets for American products in the newly industrialized countries.
- Protectionist measures whether to limit imports or to discourage foreign direct investment in the United States should be avoided at all costs. Protection only invites retaliation. Even if there were no retaliation, protectionist policies would strengthen the dollar making US exporters less competitive. Foreign investment is likely to benefit the economy even though in some cases it will hurt entrenched American firms.

Exchange Rate Policies

- Efforts to stabilize exchange rates at current levels are misguided. They run very serious risks of throwing the economy into recession and make an eventual financial collapse more likely. American monetary policy should be directed at insuring continued economic growth as the budget deficit declines, not at arbitrary exchange rate targets. Policymakers should recognize that a continued dollar decline is both likely and desirable.
- Rapid growth in the world economy and the expanding markets that it brings about are crucial to the health of the manufacturing sector. As the United States brings its current account back into balance, it should encourage other nations to stimulate domestic demand to replace export demand.

INTRODUCTION

The competitive problems of American manufacturing firms have caught the attention of policymakers, the press and the public in the last few years as never before. Record trade deficits, significant foreign penetration of American markets, declining rates of real wage and productivity growth, and low profitability are all symptoms of the serious underlying problems confronting U.S. manufacturing. This report seeks to diagnose and suggest treatments for the serious ills that afflict the American manufacturing sector.

We begin by reviewing the role of the American manufacturing sector in the American and world economies. It is readily apparent that the economic importance of manufacturing is disproportionate to its relative share in the economy. While manufacturing contributes one fifth of national output, it does more than ninety five percent of the economy's private research and development. It is an important provider of high-wage jobs and a major source of product demand for other sectors. The importance of the manufacturing sector makes it particularly alarming that it has experienced declining employment and deteriorating world market share in recent years.

Many discussions of the problems facing the manufacturing sector emphasize factors specific to particular industries or firms, such as product quality or trade barriers. While these issues no doubt have a role, the suddenness with which the competitiveness problem arose suggests the need to look elsewhere for its primary causes. American management practices and product quality did not deteriorate abruptly in the 1980s, yet the trade deficit ballooned. There is little evidence that trade barriers against American goods have increased in recent years, although they are a significant problem. Instead, the changes in the economic environment that have caused problems for manufacturing principally have involved macroeconomic policies.

This report concentrates on three areas where changes could do a great deal to restore the health of American manufacturing: fiscal policy, monetary policy, and structural trade policy.

The most serious policy problem for the manufacturing sector is the continuation of large Federal budget deficits. Federal deficits have absorbed more than two-thirds of private saving in recent years, and national saving has averaged less than three percent of GNP. Low national saving hurts manufacturing in two ways. First, it reduces the supply of capital and chokes off much needed investment. This hurts manufacturers in their role as producers of capital equipment, and it discourages them from making productivity enhancing investments. Second, the low national saving rate forces the United States to borrow from abroad in order to finance investment. This makes trade deficits inevitable. The composition of U.S. trade implies that a large part of the burden from a rising trade deficit falls on manufacturing industries.

Reducing Federal deficits will require both spending cuts and increased taxes. Spending must be scaled back in areas of the budget like Social Security that have heretofore been sacrosanct. In the short run, various excise taxes could generate significant increases in Federal revenues, but for the long run, a new national consumption tax should receive serious consideration.

Reducing Federal deficits is the most potent and reliable way to increase national saving. But the enormity of the gap between American and foreign saving and investment rates, also justifies policies to stimulate private saving and to encourage investment. Structural tax policies can play an important role here, particularly in stimulating productivity enhancing investments in equipment. Unfortunately the Tax Reform Act of 1986 did more to stimulate consumption than investment, and constituted a step backwards in this respect. Serious consideration should be given to restoring the investment tax credit, possibly on an incremental basis.

A second crucial problem for American manufacturers in recent years has been the extraordinary movements in the exchange value of the dollar. The strong dollar has been, and continues to be, the proximate cause of the reduced competitiveness of American manufacturing firms.

Manufacturing competes on world markets. If an overly strong dollar lowers Japanese wages measured in dollars, then Japanese firms are in an extraordinary position to gain market share in the United States and other countries. While the dollar has come way down from its peak levels, our reading of the evidence indicates that it will have to fall further if trade balance is to be restored without a recession. Certainly, a balance of manufacturing trade does not appear to be within reach at current exchange rates.

Manufacturing has an additional stake in a further dollar decline. Like other sectors of the economy, manufacturing will fare much better if the economy enjoys a "soft landing" as current imbalances are unwound. The necessary deficit reduction measures will reduce demand and slow the economy. The slack can only be taken up by increased net exports, which requires a decline in the exchange rate, or by expansionary monetary policies which would have the same effect. Monetary policies directed at maintaining exchange rates near current levels would be catastrophic for the manufacturing sector. In addition to reducing foreign demand for U.S. products and increasing American demand for foreign products, tight monetary policies in defense of the exchange rate would raise interest rates and the risk of a recession. Postponing the inevitable exchange rate adjustment only magnifies the ultimate distress. The best way for monetary policy to help manufacturing as well as other sectors is to allow market forces to determine the level of the dollar. This would enable monetary policy to be directed at the crucial objective of maintaining full employment.

Much of this report focuses on exchange rate questions and the appropriate monetary-fiscal mix. In the medium and long run, the performance of manufacturing depends as well on trade policies. Until very recently, protectionism was on the rise in the wake of the sharp loss in international competitiveness. The immediate risk of major protectionist measures has abated, but the need to establish a more aggressive export-oriented trade policy remains. This is not as urgent as policy action in the macroeconomic sphere, but failure to establish appropriate policies may unnecessarily delay or even jeopardize major U.S. export opportunities in foreign markets.

With respect to structural trade policies, the key is to avoid doing the wrong thing. The temptation to protect American firms from foreign competition is very strong given our large trade deficit. Nonetheless protectionist measures, whether to limit imports or to discourage foreign direct investment, should be avoided at all costs. Protection only invites retaliation. Even if there were no retaliation, protectionist policies would strengthen the dollar and make American exporters less competitive. Limiting foreign investment in the U.S. is equally bad policy for all the reasons we prod developing countries to liberalize their foreign investment regimes.

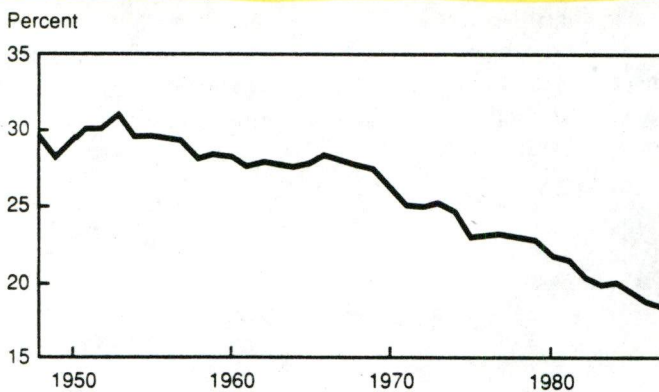
I. MANUFACTURING AND THE AMERICAN ECONOMY

The health of the American manufacturing sector and the American economy are closely related. American manufacturers cannot remain competitive unless the aggregate economy prospers, and it is very unlikely that aggregate economic activity can grow rapidly without a thriving manufacturing sector. This section begins by suggesting several reasons why a strong and growing manufacturing sector may serve as a potent stimulus to economic growth. We then investigate these links by highlighting the manufacturing sector's special sensitivity to both cyclical fluctuations and to movements in the balance of trade. We conclude by providing a global perspective on the recent performance of the U.S. manufacturing sector, focusing on its role in world trade and its growth relative to the manufacturing sectors of other industrialized nations.

The manufacturing sector employs about twenty percent of the nation's workforce. Manufacturing employment as a share of total employment has been declining for over three decades.

Figure 1

Manufacturing Share of Total Employment: 1948-1987



Source: US Bureau of Labor Statistics, "Employment Situation," annual averages

Figure 1 shows that manufacturing jobs accounted for over 30% of employment during the early 1950s, but only 18% of employment in 1987. Manufacturing's share of employment is now lower than at any time this century. Although the relative importance of manufacturing has declined through time, its absolute size has grown for most of the postwar period. Between 1950 and 1980, for example, the number of manufacturing jobs increased by nearly five million. The 1980s differ from earlier decades, however, because this absolute growth trend has been reversed. Manufacturing firms employed 19.1 million persons in 1987, a decline of 1.2 million from the level in 1980 and almost two million from the peak manufacturing employment level in 1979. This absolute decline in manufacturing employment, despite robust economic growth in recent years, accounts in part for recent concern with the health of American manufacturing.

The Integral Role of Manufacturing in the U.S. Economy

Manufacturing's share of employment substantially understates the sector's importance: without a viable manufacturing sector, the American economy will not be able to provide rising standards of living to workers while also permitting producers to remain competitive on world markets. We develop three aspects of this argument: the role of manufacturing in technological progress, the quality of jobs it provides, and its important linkages to the broader economy.

Numerous studies have shown that the primary source of economic growth is improved production techniques that allow increased amounts of output to be produced from given amounts of capital and labor. Such technical improvements, as well as improved products, derive from research and development expenditures. These expenditures benefit not only the firms that make them, but also competitors who emulate successful products and production techniques and customers who are able to purchase goods at lower cost. Since those who spend on research and development do not capture all the benefits, ensuring an adequate level of research and development is a chronic economic problem. That is the justification for government funding of basic research, and other public policies.

Table 1 illustrates the crucial role of manufacturing industries in spurring technical progress. While manufacturing accounted for 20.7 percent of gross domestic product in 1984, it was responsible for 96.3 percent of all R&D expenditures. Each dollar of manufacturing value added is associated with 8.9 cents of R&D spending, while a dollar of value added in the non-manufacturing sector is accompanied by less than one-tenth of one cent of R&D. The central role of manufacturing in undertaking R&D underscores the need for a healthy manufacturing sector if American business is to maintain an adequate rate of research spending in the coming decades.

Table 1
The Importance of Manufacturing to Research & Development

	Manufacturing	Non-Manufacturing
R&D Expenditures (\$ billion, 1984)	69.0	2.6
R&D/Value Added	.089	.001
R&D/Employee (\$ thousands, 1984)	3.610	.035

Source: National Science Foundation, Bureau of Labor Statistics.

WHAT ABOUT AUTOMATION!

The greater tendency for manufacturing firms to invest in research and development reflects the greater opportunities for technical progress in manufacturing relative to other sectors of the economy. While measurement problems make it difficult to compare productivity growth in manufacturing with that in other sectors, estimates of productivity growth supplied by the Bureau of Labor Statistics support this view. Productivity is higher, and grows faster, in manufacturing than in other industries. The quantity of output produced per hour of worker input in manufacturing has grown nearly 3.5% per year since 1970. Nonmanufacturing productivity has increased only 0.3% per year. Similar differentials for other postwar periods are shown in Table 2.

Table 2
Productivity Trends in Manufacturing and Other Sectors
(% Per Year)

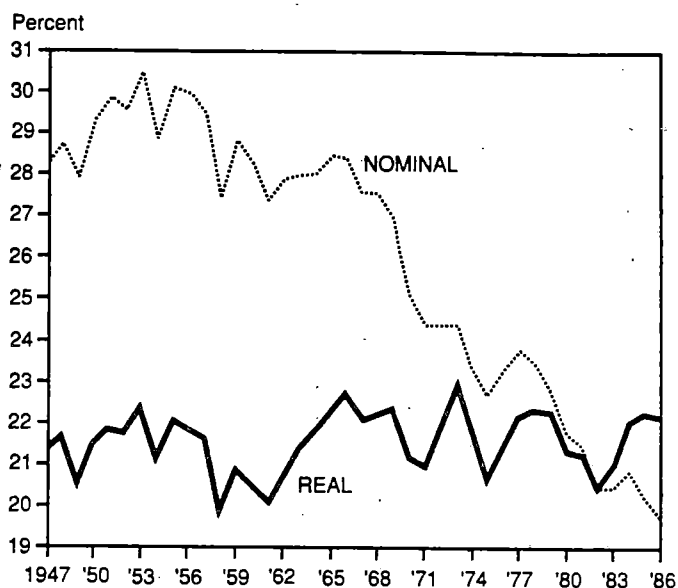
	Manufacturing	Non-Manufacturing
1950-1986	2.70	1.54
1950-1973	2.79	2.25
1974-1986	2.53	0.21
1980-1986	3.49	0.32

Source: BLS. Non-manufacturing denotes private, non-farm, non-manufacturing.

The pattern of especially rapid productivity growth in manufacturing is a worldwide phenomenon. During the period 1973-1984, manufacturing productivity exceeded that in all other sectors by 1.75 percent per year in the United States, by 5.4 percent per year in Japan, and by 2.9 percent per year in Europe. Countries that specialize in producing products where productivity rises rapidly are likely to enjoy more rapid growth than those that produce products where growth is stagnant. This partly explains the keen international competition in manufacturing industries.

Productivity differentials explain why some measures show no decline in manufacturing's role in the U.S. economy. Figure 2 presents the share of manufacturing in gross domestic product. The solid line shows the share holding the relative prices of different goods constant at their 1982 levels. It demonstrates that manufacturing has accounted for just over twenty percent of output throughout the postwar period. If the calculation is based on actual prices in different years, however, as the broken line demonstrates, the manufacturing share of output declines in tandem with the manufacturing share of employment. The difference between the constant-price and actual-price calculations is dramatic because rapid productivity growth in manufacturing has lowered the relative price of manufactured goods throughout the last three decades.

Figure 2
The Share of Manufacturing in GDP



In addition to spurring technical advance, a developed manufacturing sector also provides good jobs to workers. Average hourly compensation in manufacturing is higher than compensation in many other sectors. Table 3 presents summary information on compensation in different sectors throughout the postwar period. The gap between wages in manufacturing and in the rest of the economy has changed relatively little through time: manufacturing jobs consistently appear to pay more than 20% more than jobs in the non-manufacturing sector, and nearly 30% more than service sector jobs.

Table 3
Hourly Compensation in Manufacturing and Other Sectors
(1986 \$ per hour)

	Manufacturing	Services	Trade	Total Non-Manufacturing
1950-86	\$12.26	8.47	9.72	8.85
1986	\$15.70	12.17	10.81	12.75

Source: Department of Commerce, Bureau of Labor Statistics.

The explanation of wage differentials between manufacturing and other sectors is not entirely clear. In part, the pay differential reflects the greater extent of unionization in the manufacturing sector. In part, it reflects the fact that manufacturing workers are on average older and better educated than those in other sectors of the economy. As Table 4 shows, however, these factors cannot explain the entire differential.

Table 4
Interindustry Wage Differentials
(Deviation from All-Industry Average)

Industry	Wage Deviation
Transport & Public Utilities	+22.9%
Mining	+19.3%
Construction	+12.3%
Manufacturing	+9.7%
Wholesale & Retail Trade	-9.3%
Finance, Insurance, and Real Estate	-13.2%
Services	-16.4%

Source: Alan Krueger and Lawrence Summers, "Efficiency Wages and the Wage Structure," National Bureau of Economic Research Working Paper 1952, June 1986. These estimates correct for differences in age, experience, and schooling between individuals in different industries.

Manufacturing firms may choose to pay workers higher wages than those in other industries for a variety of reasons. First, the integrated character of manufacturing production puts a premium on development of a stable and cooperative work force, objectives which are fostered by a high wage policy. Second, the nature of production in many manufacturing industries requires workers to develop specific skills on the job that justify the payment of high wages. Third, higher productivity in manufacturing may enable firms to pay higher wages than those available in other industries. While the relative importance of these different factors in determining the manufacturing wage premium remain unclear, the implications of the manufacturing wage premium are apparent: more high wage jobs are likely to result from expansion of the manufacturing sector than from expansion of other sectors. The higher level of wages in manufacturing signals the greater productivity of additional manufacturing workers. Economies with large and expanding manufacturing sectors will grow faster than those with small and contracting manufacturing bases.

A final reason for the manufacturing sector's disproportionate influence is its close linkage to other sectors of the economy. In 1986, value added in manufacturing was 799 billion dollars or 20.1 percent of gross domestic product. However, shipments by manufacturing companies equalled \$2279 billion or 57.4 percent of GDP. The difference of \$1480 billion, 37.3 percent of GDP, represents the manufacturing sector's

purchases from other firms. While some intermediate goods are imported, manufacturing firms constitute a significant source of demand for the output of other industries. This is illustrated in Table 5, which shows the increase in unemployment rates in sectors other than manufacturing that results from a one percentage point rise in manufacturing unemployment. This table explains why the whole economy has a large stake in the manufacturing sector's performance.

Table 5
Spillover Effects of Manufacturing Unemployment

Sector	Increase in Sector Unemployment Rate from One Point of Manufacturing Unemployment
Construction	3.2
Wholesale Trade	1.4
Retail Trade	1.5
Finance, Insurance, Real Estate	0.7
Services	2.4
Professional	-0.1
Government	1.0
Weighted Sum	2.0

Source: Kevin J. Murphy and Robert Topel, "Unemployment in the United States," in NBER MACROECONOMICS ANNUAL, 1987, Stanley Fischer, ed.

Manufacturing linkages are important in an additional sense as well, since many services that feature prominently in visions of the "post industrial economy," such as education, banking, and communications, are demanded in significant part by the manufacturing sector. The health of these progressive parts of the service sector is therefore tied to the performance of American manufacturing firms.

The three considerations reviewed here—technical progress, quality of jobs, and interindustry linkages—all suggest that a strong manufacturing sector is important to a prosperous American economy. Hence, policy should seek to remove artificial impediments to American manufacturing, and to create an environment where industrial firms have strong incentives to expand output and employment. The next two sections documents the recent experience of the U.S. manufacturing sector and places the domestic manufacturing sector in the world context.

U.S. Manufacturing in the U.S. Economy

Despite manufacturing's stable share of constant-dollar national output, the sector bears a disproportionate share of cyclical fluctuations. A one percent decline in aggregate output has historically been associated with a 2.2 percent decline in manufacturing output. Between 1981 and 1982, for example, gross domestic product declined by 2.5 percent but the output of the manufacturing sector

declined by 4.5 percent. Durable goods manufacturers are especially sensitive to cyclical fluctuations because of the volatility in spending on both consumer durables and investment. Between 1981 and 1982, durable manufacturing output declined over ten percent.

Table 6 presents the changes in real manufacturing output, and the output of non-manufacturing firms, between business cycle peaks and troughs since World War II. The table shows that manufacturing's greater volatility during the 1982 recession is not an outlier.

Table 6
Percentage Change in Output,
Manufacturing and non-Manufacturing

	Manufacturing	Non-manufacturing
Economic Upturns:		
1954 to 1957	12.1%	8.6%
1958 to 1960	11.6%	7.3%
1961 to 1969	58.1%	37.8%
1970 to 1973	22.6%	10.5%
1975 to 1980	21.5%	16.4%
1982 to present (1986)	28.0%	15.8%
Economic Downturns:		
1953 to 1954	-7.3%	0.3%
1957 to 1958	-8.7%	1.6%
1960 to 1961	0.2%	3.2%
1969 to 1970	-5.6%	1.2%
1973 to 1975	-11.9%	1.3%
1981 to 1982	-6.1%	-1.5%

Source: Commerce Department. Turning point years based on National Bureau of Economic Research dating of business cycle.

The average increase in manufacturing output during expansions is 25.7%, compared with 16.1% in non-manufacturing sectors. Manufacturing output typically declines 6.6 percent during a downturn, compared with a one percent output increase during similar periods in non-manufacturing.

Just as manufacturing firms bear the brunt of cyclical fluctuations, they also bear the burden of macroeconomic policies that generate substantial trade imbalances. Table 7 shows the changes in the composition of the U.S. trade balance between 1979 and 1985. Two conclusions are clear. First, virtually all of the swing in the overall trade balance during this period is accounted for by movements in manufacturing trade. Second, manufacturing trade dwarfs trade in services. Policies that cause the U.S. to run trade deficits therefore inevitably have a large impact on the manufacturing sector.

Table 7
U.S. Manufacturing and Trade
(Percent of Gross Domestic Product,
Business Cycle Peak Years)

	1969	1973	1979	1985
Current Account/GDP	.04	.53	-.04	-2.97
Merchandise Trade	.06	.07	-1.12	-3.14
(of which Manufacturing)	.18	.02	.17	-2.61
Service Trade	.64	.90	1.38	.63

Source: G. Hatsopoulos and P. Krugman, "The Problem of U.S. Competitiveness in Manufacturing," *New England Economic Review*, January/February 1987.

The performance of manufacturing in the 1980s has been substantially improved by one important domestic policy development: the U.S. defense build-up. The manufacturing sector is a substantial beneficiary of defense spending. The Bureau of Labor Statistics estimates that fifty seven percent of all private employment that is generated by defense spending is within the manufacturing sector, primarily durable manufacturing. The Bureau also calculates that defense spending was directly responsible for 1.04 million manufacturing jobs in 1977, 1.20 million in 1980, and 1.81 million in 1985. Between 1980 and 1986, when total manufacturing employment contracted by 1.29 million, defense-related employment actually increased by .74 million. These statistics imply striking heterogeneity in the experience of defense-related and other parts of manufacturing, since non-defense manufacturing employment has declined by just over two million jobs during the last six years. Had defense spending remained constant at its 1980 level throughout the decade, manufacturing employment in 1986 would have been 18.3 million, more than ten percent below its level only six years earlier.

The roll of defense in bolstering the manufacturing sector must be highlighted for three reasons. First, without the defense buildup manufacturing employment in 1987 would be nearly three million below its peak in 1979, and at its lowest absolute level since 1965. This would imply a much faster rate of manufacturing contraction during the 1980s than in either the 1960s or 1970s. Second, the tightened fiscal environment of the late 1980s and early 1990s makes future expansion in defense outlays unlikely. Significant spending cuts, relative to the levels of the early 1980s, are the most probable course. Just as the manufacturing sector benefits the most when defense spending increases, it will be the largest loser as spending declines. Finally, reduced defense spending is likely to have particularly large effects on a small group of industries. The U.S. shipbuilding industry, for example, sells 93 percent of its output to the federal government. Two thirds of the aircraft industry's final sales, and more than three quarters

of sales by munitions firms and the manufacturers of aircraft and missile engines, are purchased by the federal government. Defense cutbacks will therefore lead to rather concentrated employment reductions.

U.S. Manufacturing: The Global Perspective

We saw previously that manufacturing has remained relatively constant as a share of constant dollar GNP. This fact is often adduced as a counterpoint in the discussion about poor U.S. manufacturing performance and deindustrialization. It does not, however, address the question of whether U.S. manufacturing could be doing better. This can be investigated by comparing the recent performance of the manufacturing sectors in the U.S. and other nations.

To judge the performance of the United States in a global context we look at relative growth rates and shares of manufacturing in trade and production. Consider first the U.S. performance in world trade. In the past fifteen years the U.S. share of trade in manufactured goods has been eroded by the emergence of major competitors such as Japan and the NICs. The loss of international competitiveness can be documented by examining the U.S. share in world manufactures trade. Although the U.S. share in the dollar value of world trade has hardly changed during the last fifteen years, this conceals poor performance on volumes because of the overvaluation of the 1980s. Table 8 shows the behavior of manufactures export volumes for the U.S., Japan, Europe, and the world. The simplest way to read this table is to compare the average growth rate of U.S. manufactures exports with that of the world. For the last fifteen years, U.S. exports have grown three percent less per year than those of the rest of the world. Data for 1986-87 will not change that evidence; on the contrary, while exports have been rapidly rising, imports are still increasing and their level is significantly higher than previously.

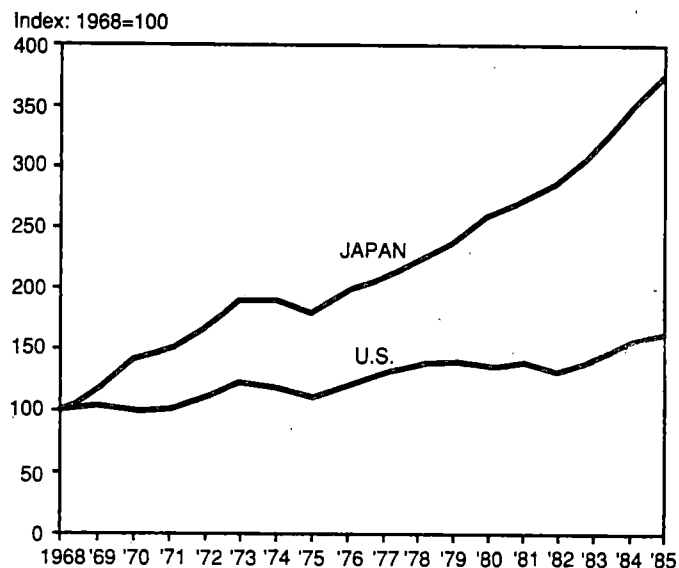
Table 8
Volume of Manufactures Exports
(Index 1980 = 100)

	1970	1980	1981	1985	Avg. Growth Rate 1970-85 (%)
U.S.	49	100	96	81	3.4
Japan	39	100	111	142	9.0
Europe	56	100	103	122	5.3
Developing Countries	30	100	110	188	13.0
World Exports	51	100	104	130	6.4

Source: United Nations

Some might argue that trade volumes cannot accurately reflect U.S. manufacturing performance because in past years the United States has grown rapidly relative to the rest of the world. As a result, U.S. exports to the slow growing rest of the world would tend to rise less than foreign exports which include exports to the United States. Even this argument cannot be viewed favorably. Between 1968 and 1985, manufacturing value added grew at an annual rate of 7.9 percent in Japan, 4.4 percent OECD countries other than the U.S., and only 2.7 percent in the U.S. Figure 3 contrasts manufacturing growth in Japan, the country with the highest average growth among industrial nations, and the U.S.

Figure 3
Manufacturing GDP



Even considering shares in the value of trade we can find a significant deterioration of the U.S. position in some industries. Electronic goods are a clear example. In the period 1979 to 1985 the U.S. share in industrial countries' exports declined by 4.3 percent in automatic data processing equipment, 2.3 percent in consumer electronics, 6.3 percent in electronic parts, and 2.8 percent in business electronics. For other high technology products the decline is quite apparent even when we exclude the rapidly growing exports from the Southeast Asian NICs.

The absolute growth of manufacturing here and abroad, shown in Table 8, suggests that the U.S. has done relatively poorly. Further evidence in the same direction appears in Table 9, which compares the ratio of manufacturing value added to GDP for the U.S. and other countries. Manufacturing shares measured in current prices are declining everywhere, but more so in the U.S. than abroad! The relative performance in manufacturing using constant price measures to indicate whether manufacturing is a growing or declining share of economic activity also

evidences weak U.S. experience. Since 1979, manufacturing output grew 2.5 percent per year in the non-U.S. OECD countries (7.9 percent in Japan), but only 2.2 percent per year in the U.S. While the non-U.S. OECD experienced non-manufacturing growth of 2.1 percent (4.0 percent in Japan), in the U.S. the non-manufacturing sector grew 2.5 percent per year. These trends are at least in part attributable to higher rates of manufacturing productivity growth in other nations. Table 10 presents comparative evidence on this question:

Table 9
Manufacturing Share in GDP
(Percent of GDP)

	U.S.	Japan	Europe	Non-U.S. OECD
1960	28.3	33.9	31.5	30.7
1975	22.7	30.2	28.2	27.7
1980	21.8	29.2	26.9	26.7
1985	20.4	29.8	25.6	25.9

Source: OECD Historical Statistics

Table 10
Average Annual Manufacturing
Productivity Growth

	U.S.	Japan	Europe	Non-U.S. OECD
1960-68	3.2	9.0	5.1	5.2
1968-79	2.4	7.7	4.0	4.6
1979-85	3.5	6.3	2.8	3.6

Source: OECD Historical Statistics

Lower productivity growth affects cost competitiveness and the standard of living. It implies that real wages cannot rise as rapidly as they can in high productivity growth countries, or, if they do, cost competitiveness is lost.

One of the consequences of the slower productivity growth rate in the United States is displayed in Table 11, which reports the import penetration ratios for U.S. markets. Import penetration is defined as the share of imports in apparent consumption, i.e. production less exports. The evolution of import penetration in the past seven years is nothing short of dramatic, both in the size and speed of the change. (Figures 4 and 5 plot the evolution of this data series).

Table 11
Import Penetration
(Percent of Apparent Consumption)

	Consumer Goods	Capital Goods
1980	6.9	14.6
1987	11.6	37.7

Source: Federal Reserve Board; 1987 value is average for Q1-Q3

Figure 4
Capital Goods: Import Penetration

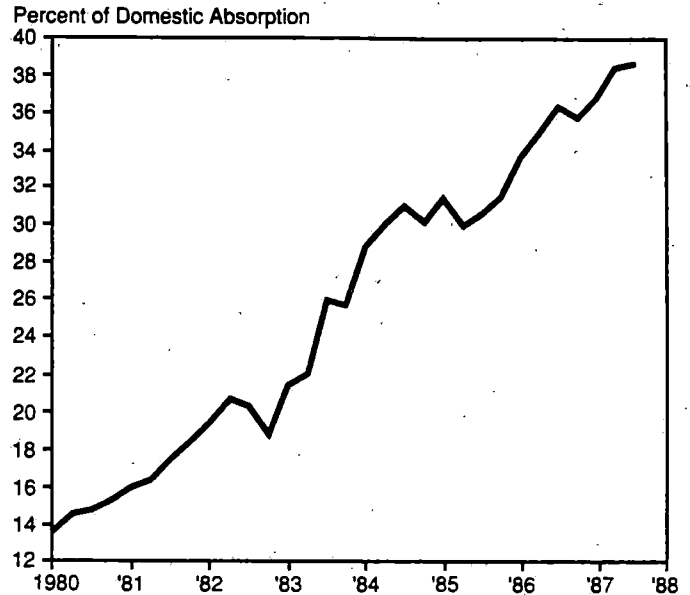
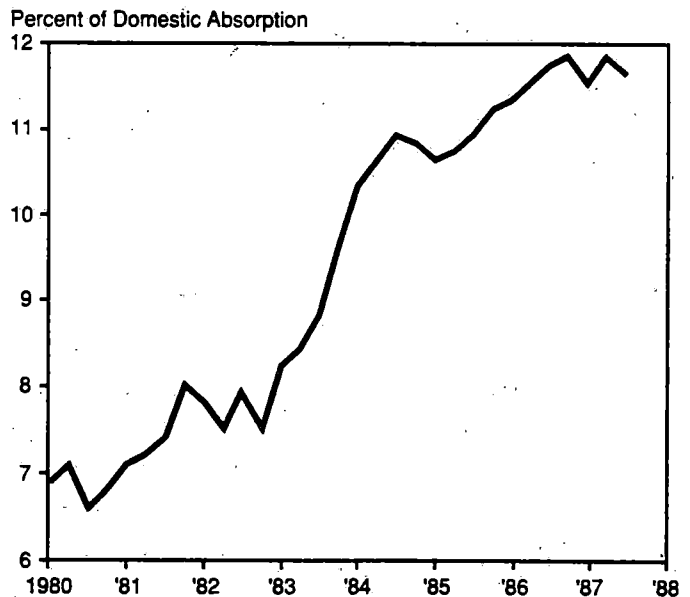


Figure 5
Consumer Goods: Import Penetration



Rising import penetration in the capital goods sector is particularly dramatic: today nearly 40 percent of all equipment is imported. Whereas relative export growth rates may misrepresent manufacturing performance because export markets may experience different growth rates, the import penetration ratio tells an unambiguous story: U.S. manufacturing has been falling far behind, losing market share in the home market.

To illustrate these changes in ability to compete at home we look at U.S. relative performance in high technology trade. Table 12 shows the U.S. trade balance for various products. While there continues to be a trade surplus for some categories, there is also a uniform pattern of decline. The trade surplus in all high technology trade fell from nearly 60 percent of exports to less than 30 percent between 1980 and 1985.

Table 12
High Technology Balance of Trade
(Billion \$)

	1980	1985
Total	27.4	11.7
Drugs	1.0	0.8
Industrial Organic Chemicals	4.2	2.8
Computers and Office Equipment	6.2	2.6
Communications Equipment	0.2	-2.0
Electronic Components	0.9	-4.2
Aircraft and Parts	11.9	12.7
Scientific Instruments	3.0	-1.0

Source: GATT

The statistics presented above suggest that in Japan and in all non-U.S. OECD countries as a group, manufacturing is growing more rapidly than total output and thus the importance of manufacturing in economic activity is rising.

In the U.S. by contrast manufacturing is at best constant, or even falling if we look at the 1979-85 period. Thus, by international standards, U.S. manufacturing is performing poorly: our share in world trade has been falling, and import penetration in our own market has increased dramatically.

It is sometimes argued that the relative decline of U.S. manufacturing was inevitable, that our post-war dominance was unsustainable. That is too easy a way to rationalize the evidence. We will argue below that policies, such as an overvalued dollar, have vastly facilitated and accelerated this decline unnecessarily. We need to ask whether the U.S. can afford to continue yielding markets abroad and our own market to foreign suppliers? Large budget deficits in the past few years have masked our decline and created the illusion that the U.S. economy can muster strong growth. In fact, in terms of our standard of living, we are falling behind. Inappropriate macroeconomic policies are as important in explaining our poor performance as any catching up process abroad. Hence, the notion that there is no need for alarm or that there is nothing we can do as we lose out in all fields must be firmly rejected. The next two sections consider how exchange rate and fiscal policies have contributed to our poor performance as it emerges in an international comparison.

II. FISCAL POLICIES AND U.S. MANUFACTURING

The competitive problems of American manufacturing have many sources. Our low national saving rate is the most important cause of the huge U.S. trade deficit and the consequent weakness of American manufacturing. While the federal government can have only a limited impact on foreign trade practices or the attitudes of American management, there is a great deal that tax and fiscal policies can do to increase our national saving rate.

The American National Saving Problem

A country's current account deficit equals the difference between its national saving and investment rates. Nations like the United States that invest more than they save borrow funds from abroad. The only way foreign funds can come into the United States is for Americans to import more than they export. Japan's situation is the mirror image of that of the United States. Japan saves more than it invests and so runs chronic current account surpluses.

Table 13
National Saving and Investment,
U.S. and Japan (Percent of GNP)

Year	Japan		
	Net National Saving	Net National Investment	Current Account Balance
1975	19.4%	19.9%	-0.5%
1980	18.3%	19.5%	-1.2%
1981	18.5%	18.6%	-0.1%
1982	17.9%	17.5%	0.4%
1983	17.0%	15.5%	1.5%
1984	18.2%	15.7%	2.5%
1985	16.7%	13.0%	3.7%
1986	—	—	—
Year	United States		
	Net National Saving	Net National Investment	Current Account Balance
1975	2.8%	2.1%	0.7%
1980	4.4%	4.2%	0.2%
1981	5.3%	5.2%	0.1%
1982	2.0%	2.0%	0.0%
1983	2.0%	3.2%	-1.2%
1984	4.5%	7.1%	-2.6%
1985	3.2%	6.2%	-3.0%
1986	2.0%	5.5%	-3.5%

Source: OECD Quarterly Income Accounts.

Table 13 displays the recent history of U.S. and Japanese national saving rates. It is clear that reduced national saving is the primary reason for the deterioration in America's trade performance. With a national saving rate below 3 percent, as in the last few years, the United States

must choose between two unpleasant alternatives: borrowing on a massive scale from abroad, with the attendant dislocations in the manufacturing sector which is subject to international competition; or reducing further our rate of net investment from its current low level.

Low national saving is the ultimate cause of other problems that are frequently identified as barriers to U.S. competitiveness. The high level of the dollar in the early 1980s was a direct result of capital inflows caused by the high interest rates. The lasting effects of high exchange rates, which dislodged American firms from many of their traditional markets both at home and abroad, are still being felt. While monetary factors have caused the dollar to decline substantially since February of 1985, trade balance remains impossible at current levels. As the dollar declines to a level where trade balances, the U.S. will cease borrowing from abroad. Instead, it will have to rely on its supply of domestic saving to finance investment. Failure to increase domestic saving will induce a dramatic increase in the cost of capital and a sharp decline in the American investment rate.

It is often suggested that a high cost of capital inhibits American investment and encourages myopia amongst American managers. Table 14 illustrates that American manufacturers face much higher costs of capital than their Japanese counterparts.

Table 14
Cost of Capital Differential
Between U.S. and Japan

	Real Interest Rate	Earnings-Price Ratio	Cost of Capital
U.S.	6.6%	8.5%	12.9%
Japan	3.2%	3.8%	8.4%

Source: G.N. Hatsopoulos and S.H. Brooks, "The Gap in the Cost of Capital, in R. Landau and D. Jorgenson, eds., *Technology and Economic Policy* (Cambridge: Ballinger Publishers, 1986).

An American manager facing the capital cost in Table 14 would be willing to invest \$.37 in return for a dollar six years from now, compared with \$.66 for his Japanese counterpart. It is hardly surprising that Japanese managers often appear to take a longer view than American executives. A key reason for the cost of capital differential is that Japan's high saving rate increases the supply of capital available to Japanese firms, while the low saving rate in the U.S. makes capital scarce and drives up its cost.

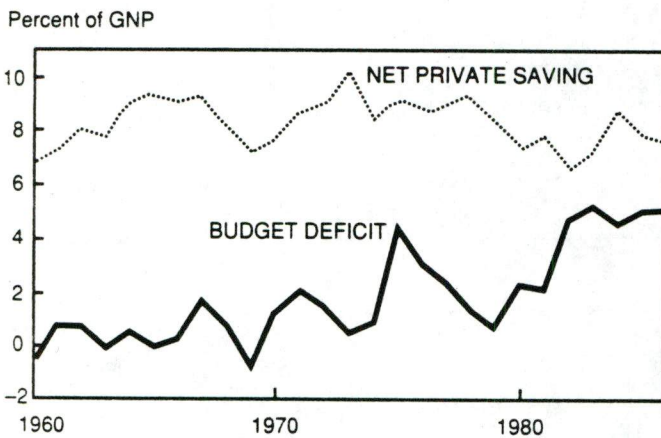
These considerations suggest that raising our national saving rate is essential if American manufacturers are to regain competitiveness on world markets. Increased saving will reduce the U.S. cost of capital, encouraging the long

horizon investments needed for productivity growth. It will also obviate the need for capital flows and the attendant exchange rate misalignments that preclude effective competition for many manufacturing firms.

Federal Deficits and National Saving

The most potent and reliable way to increase national saving is to reduce the federal budget deficit. Figure 6 shows that federal borrowing has absorbed a large and increasing share of private saving in recent years, depressing our national saving rate. In 1986, dissaving by the federal government was ninety percent as large as the flow of private saving generated by households and corporations. **While the federal deficit fell by almost one third between 1986 and 1987, this decline was largely a reflection of transitory factors relating to the Tax Reform Act and the sale of federal assets.** As a consequence, official projections call for federal deficits approaching \$200 billion in coming years if substantial policy changes are not enacted.

**Figure 6
Budget Deficits and Private Saving (1960-1986)**



The major growth area in the federal budget where spending cuts are possible is Social Security. Table 15 presents the growth rates of Social Security benefits and average hourly earnings during the last two decades.

**Table 15
Growth of Disposable Income and
Social Security Benefits, 1970-1985**

	Real Per Capita Disposable Income	Real Social Security Benefits
1970	100.0	100.0
1975	112.0	133.5
1980	123.3	145.5
1985	132.0	153.8

Source: Council of Economic Advisors, and Bureau of Labor Statistics. 1970 values normalized to 100 by the authors.

Social Security benefits have risen much more rapidly than wages over this period, due to a combination of slow productivity growth and generous indexing provisions. Since 1970, real Social Security benefits have grown one percent per year faster than wages. One attractive option for reducing net outlays on Social Security while inflicting minimal hardship on program beneficiaries involves taxing the portion of benefits that do not represent the return of workers' contributions. Such a policy would reduce Social Security expenditures by \$19 billion per year in 1992, but it would principally affect upper-income elderly households for whom Social Security is only one component of family income.

The political difficulty in generating support for sizable reductions in real Social Security benefits, coupled with the need for new revenues to support spending on emerging priorities like education, infrastructure, and civilian R&D and the need to restore tax incentives to spur saving and investment, makes a tax increase in the next few years almost inevitable. The challenge for economic policy will be to choose tax measures that do not interfere with competitiveness by interfering with incentives to save or invest. Two broad approaches are possible—piecemeal reforms that raise taxes on socially harmful activities, and broad based value added taxes that raise revenue with minimal effects on economic incentives.

Several piecemeal reforms on both the tax and spending sides of the budget could trim the deficit while creating desirable economic incentives. These include:

- Restoring taxes on cigarettes and distilled spirits to their 1952 level (in real terms) and equalizing the tax rates on alcoholic beverages. These taxes would raise more than \$10 billion a year.
- Requiring firms to amortize their advertising outlays. Since annual advertising spending by U.S. corporations totals approximately \$75 billion, this policy would raise up to \$10 billion a year over the next several years. It would also reduce the current tax bias towards promotional outlays and away from productivity enhancing new investments in plant and equipment.
- Increasing the gasoline excise tax by ten cents per gallon. This would raise \$9 billion a year and also encourage energy conservation. Unlike a general oil import fee it would not burden the many companies that use energy products as an intermediate good in their production.

Handwritten calculations: $200 \overline{) 5500}$ and $2 \overline{) 55}$ with a result of 2.270.

Call to Counsel Eco Advisors, Steve Lampfeld 5084

- *Imposing taxes on portfolio income earned in the United States by foreigners. This could raise about \$5 billion a year and at the same time promote U.S. competitiveness by reducing capital inflows.*
- *Tightening the enforcement of existing tax laws. While the precise revenue yield from increased enforcement is uncertain, approximately \$100 billion of potential revenue is lost each year due to tax evasion. There is little doubt that increases in the Internal Revenue Service budget are repaid several times over with increased revenues. This strategy for raising revenue would encourage obedience to the law, at the possible cost of harassing some taxpayers. A number of states, however, have succeeded in raising revenues through enhanced enforcement.*

This package of competitiveness-enhancing tax measures could raise up to \$50 billion annually without rescinding any of the 1986 tax reforms. It would not entail any increase in tax burdens on savers, investors, or industries facing international competition. The package represents an attractive first step in attacking the deficit problem, but it may not adequately reduce the budget deficit. This is especially likely if Congress chooses to enact new spending programs, or if some of the incentives for saving and investment are restored to the tax code.

The most effective device for significantly reducing the federal deficit without undue distortions of individuals' work and saving decisions is a broad-based value added tax. Value added taxes, a principal revenue source in most European nations, are a form of consumption tax. In the United States, even a value added tax at a relatively low rate would raise enough revenue to significantly reduce the federal deficit. If levied on a comprehensive base of consumption goods, the VAT would raise \$21 billion for each percentage point of the tax rate. A five percent VAT, therefore, would raise more than \$100 billion and provide a natural complement to the competitiveness-enhancing tax package described above.

Those who oppose adopting a consumption tax typically raise two arguments: that the tax is regressive and unfair, and that once the tax was in place Congress would find it easy to increase the rate and therefore to finance additional outlays. The first argument, regressivity, derives from the fact that low income households consume a higher fraction of their income than high-income households. This argument is flawed, however. It neglects the possibility that income fluctuations are transitory, and that consumption actually provides a better measure of economic well-being than income. On a lifetime basis consumption taxes are much more progressive than they appear to be on the basis of annual data. Furthermore, consumption or value added

taxes are more shelter-proof than income taxes: anyone who lives well has to pay them. The only way the rich can avoid these taxes is by saving, making their income available for investment, an outcome that is particularly desirable given the low U.S. saving rate.

It is also possible to modify the tax to reduce its regressivity, even as measured from annual income flows. For example, the tax base for the VAT could be defined exclusive of food, housing, and medical care. These exemptions lower the revenue yield from the tax, from \$21 to \$12.4 billion per one percentage point of tax rate. Even this more limited revenue base would still permit major inroads in reducing the federal deficit. A further option for improving equity would involve combining the value added tax with benefit increases for means-tested programs such as Aid to Families with Dependent Children and Foodstamps. The Congressional Budget Office recently estimated the cost of raising benefits through these programs to preserve the real purchasing power of recipients, concluding that per one percent tax rate the VAT would now net \$16.3 billion for the federal government.

The second argument against the VAT holds that it will fuel excessive government spending by acting as a "money machine". The current fiscal climate makes this possibility unlikely. While some European countries may have succumbed to the temptation to raise spending in the aftermath of adopting a VAT, the large deficits that are forecast for the U.S. federal government over the next few years suggest that the first priority will be providing tax revenues to pay for existing programs. We do not expect major new spending initiatives in the immediate future, even if a VAT is adopted.

Adopting a value-added tax will improve the competitive position of U.S. manufacturing principally through its favorable impact on the budget deficit. Contrary to the frequent claims of consumption tax advocates, the VAT does not provide a direct subsidy to firms that export. Consumption taxes are essentially equivalent to retail sales taxes, although the mechanics of collecting the revenue varies between particular proposals. With a value added tax, revenue is collected from each firm based on the difference between the cost of its inputs and the revenue it receives for goods sold. If a company exports a product, it does not pay any tax on its value-added for the product and in addition it may receive a rebate for the value added tax paid by its suppliers. Although this may seem like a subsidy to exported goods, the rebate in effect just compensates the exporting firm for the higher price that it paid for its inputs on account of its suppliers' taxes. This implies that there is no net subsidy to exporting. Similarly, all imported goods would be taxed, so that consumers would not detect any differential between the retail prices of domestic and imported goods.

There is room for debate about the best way to reduce the federal deficit, but not about the need to do so. It is crucial to remember that budget deficits are not an alternative to spending cuts or tax increases. They are only a device for deferring these painful measures. Running large deficits now only postpones and magnifies the painful adjustments that will ultimately be necessary.

Tax Policies to Promote Private Saving

Reducing the federal budget deficit is the single most powerful tool for raising national saving. It is important, however, not to neglect the possibility of increasing private saving. This can be done either by providing incentives for individuals to consume less and save more, or by encouraging firms to retain a higher fraction of their after-tax profits in order to increase corporate saving. We consider policies of each type in turn.

It is difficult to isolate particular factors that can account for the abrupt decline in personal saving during the 1980s. This complicates the task of suggesting methods for raising personal saving. One potentially valuable instrument in the drive to encourage saving, Individual Retirement Accounts, was unfortunately scaled back in the most recent round of tax reform. The U.S. experience with widely-available IRAs was too brief to permit a definitive estimate of how they affected saving. The central issue is the extent to which IRA saving reflects transfers of resources from other assets as opposed to "new" saving. Some studies suggest that most IRA contributions were additions to the total saving flow, with only about thirty cents of each dollar of contributions drawn from existing saving instruments.

Personal saving accounts for slightly more than half of private saving. The remainder is made up by corporate saving, the undistributed profits that firms retain and re-invest. The level of corporate saving fluctuates for a variety of reasons, most importantly the rate of pretax profitability earned on corporate investments. One policy instrument that can alter corporate saving, however, is the level of corporate income taxes. The corporate sector saves a much higher fraction of its income than the household sector. While the personal saving rate as a fraction of disposable income is about 3 percent, corporations often save more than half of their after-tax earnings for reinvestment. This pattern has important implications for private saving in light of the Tax Reform Act of 1986, which in the interest of "revenue neutrality" raised corporate tax burdens over the next five years by approximately \$120 billion while lowering individual tax rates an equal amount.

While some believe that altering the level of corporate saving does not affect the level of total private saving because households "pierce the corporate veil" and recognize the saving that corporations are doing on their account, recent evidence questions that conclusion. If household saving responds by only half as much as

corporate saving, so that a one dollar decline in corporate saving prompts a fifty cent increase in personal saving, then shifting the tax burden from individuals to firms has important consequences. In the short run, it suggests that total private saving could decline by approximately sixty billion dollars over the next five years.

Tax Policies to Promote Investment

Raising national saving is necessary but not sufficient to restore the international competitiveness of American manufacturers. It is also necessary to provide adequate incentives for plant and equipment investment. The Tax Reform Act of 1986 is particularly unfortunate from this perspective. The Act raises the tax burden on new investments by both manufacturing and non-manufacturing firms. Equipment investments are especially hard hit because of the abolition of the investment tax credit, which previously provided a 10 percent reduction in the effective purchase price of new equipment. This section quantifies the adverse effects of this legislation and then discusses a revenue-efficient method of restoring the investment tax credit.

The total tax burden on corporate investment depends principally on three features of the corporate income tax: the statutory corporate tax rate, the generosity of tax depreciation, and the rate of investment tax credit. The difference between the before-tax and the after-tax return to corporate investment projects is a useful way of summarizing the extent to which the tax system encourages or discourages investment. This difference, as a fraction of a project's pretax return, is known as the effective tax rate. For example, if an investment project yields a ten percent return before corporate taxes but only a seven percent return after-tax, its effective tax rate is 30 percent. The effective tax rate concept played a central role in the effort to "level the playing field" with the 1986 tax reforms.

Table 16 shows how recent changes in tax legislation have altered the effective tax rates on two asset categories, general industrial equipment and industrial structures. The first two entries illustrate the importance of the Economic Recovery Tax Act of 1981 in lowering the tax burden on equipment. In 1980, both equipment and structures faced substantial tax burdens, with the effective tax rate on structures more than twice that on equipment. Effective tax rates had increased during the 1970s in part because the tax system permits firms to depreciate assets based on their historic cost, and this failed to adequately compensate firms for asset decay when inflation pushed the replacement cost of assets well above these costs. The Economic Recovery Tax Act shortened depreciation lives and reduced the effective tax burden, especially on equipment. The combination of the investment tax credit and accelerated depreciation actually made the after-tax

return to some equipment investments higher than the pre-tax return, as indicated by the negative effective tax rate in 1981. The effective tax rate on structures also declined, but by much less.

Table 16
Effective Tax Rates
on Corporate Assets, 1981-1988

Year	General Industrial Equipment	Industrial Structures
1980	22.0%	50.8%
1981	-6.8%	41.7%
1986	-3.3%	45.6%
1988	38.0%	37.0%

Source: Alan J. Auerbach, "Corporate Taxation in the United States," *Brookings Papers on Economic Activity*, 1983:2, p.467, and "The Tax Reform Act of 1986 and the Cost of Capital," *Journal of Economic Perspectives*, 1 (1987), p.77.

The tax environment in 1986 was somewhat less generous to new investment than that in 1981, since legislative changes in 1982 and 1984 had weakened some of ERTA's depreciation provisions. The last two rows in Table 16 demonstrate the impact of the 1986 Tax Reform Act on investment incentives. The effective tax rate on equipment rises from -3.3 percent to 38.0 percent, substantially above the level in 1980 when there were widespread calls for tax reform. The new tax law therefore more than undoes the 1981 Act's increased investment incentives. While it does reduce the effective tax rate on structures slightly, from 46 to 37 percent, the increased tax burden on equipment is likely to discourage investment in precisely the asset categories that reflect the greatest amount of technological progress.

The 1986 tax reform raises the tax burden on investment in manufacturing and other sectors. The particular disincentive for equipment investment is likely to affect manufacturing more than other sectors, however, because manufacturing firms both use equipment and produce it. While less equipment intensive than firms in the transportation industry, manufacturing firms in 1986 used \$29,500 of equipment per worker, compared with \$15,600 per worker in the non-manufacturing sector. Raising the cost of equipment raises the production costs of manufacturing firms, raising the prices of American manufactured goods in both domestic and world markets. Reductions in the demand for equipment inevitably reduce the demand for manufacturing output, particularly in the high-technology sector.

The fundamental structure of the recent tax reform is flawed, because it reduces the incentive for new investment while providing a windfall to the owners of existing capital. The 1986 Act increases total corporate tax liabilities by about \$125 billion over five years. However, this substantially understates the adverse impact that the tax

bill is having on new investment. This is because the reduction in corporate tax rates from 46 to 34 percent has the primary effect of reducing taxes on profits earned from investments that are already in place. On the other hand, the abolition of the investment tax credit raises the tax burden on new capital. Table 17 presents a decomposition of the changes in the tax burdens on old and new capital. Over the five year period ending in 1991, the Tax Reform Act lowers the taxes on old capital by nearly seventy billion dollars, and it raises tax burdens on new capital by \$188 billion. Since the law's incentive effects depend principally on the tax facing new investments, some reduction in investment is likely due to the new legislation.

Table 17
1986 Tax Reform's Impact on New and Old Capital

	Change in Taxes on Old Capital	Change in Taxes on New Investment
1987	0.8	24.3
1988	-8.6	32.5
1989	-17.1	39.6
1990	-20.1	43.5
1991	-23.3	48.5
Total	-68.3	188.4

Source: L. Summers, "A Fair Tax Act that's Bad for Business," *Harvard Business Review*, March-April 1987.

Most discussions of how the Tax Reform Act affects investment have focused on effective tax rates, ignoring changes in other parts of the corporate tax code that increase total corporate tax payments without directly altering investment incentives. The reform's increase in average tax rates will reduce the supply of undistributed profits available for reinvestment. Some firms will find that investment projects that could have been financed from retained earnings under the previous tax law will now need to be financed by borrowing or issuing new shares. Since external finance is generally recognized as more costly than internal finance, both because of the transactions costs associated with issuing securities and the difficulties of convincing potential investors that prospective projects yield acceptable returns, the smaller supply of internal finance is also likely to reduce investment.

The need to encourage investment provides a case for reinstating the investment tax credit in some form, particularly if the economy goes into recession or investment spending lags. Restoring the full investment tax credit for equipment would cost nearly \$40 billion a year, exacerbating the budget deficit by an amount that is likely to be intolerable unless taxes are available from a new revenue source such as the VAT. It may nevertheless be possible to regain a large fraction of the credit's incentive effect at a small fraction of the cost by adopting an incremental investment tax credit. The incremental credit would apply only to the change in a firm's net capital stock.

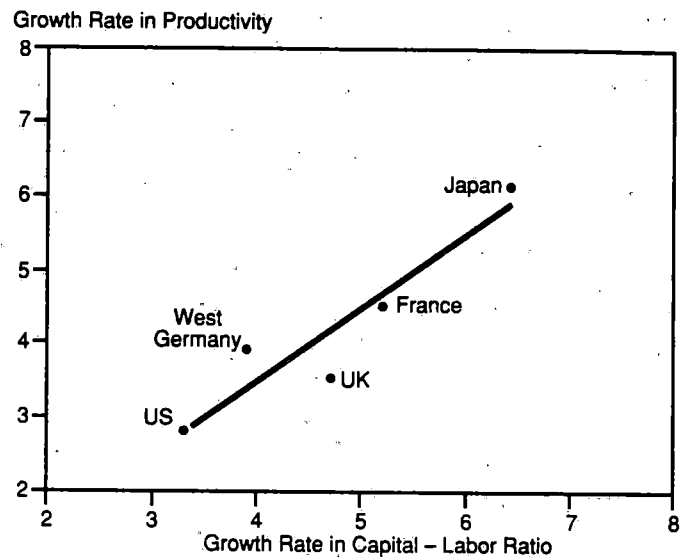
between two adjacent years. In effect, it would subsidize expansion of the net stock of plant and equipment but provide no subsidy to replacement investment.

While the precise definition of the net capital stock and net investment depends upon assumptions about the rate at which capital decays and would therefore require careful legislative drafting, the underlying principle is clear.

Applying the credit only to net investment preserves the same incentives as the existing ITC for any firm with a growing capital stock, yet it reduces the revenue cost of the investment credit by about 70 percent (the ratio of net to gross business equipment investment was .31 in 1986). Even if the incremental ITC were financed by an increase in corporate tax rates, it would provide much needed stimulus to the manufacturing sector over the next few years.

Figure 7 indicates the importance of raising rather than reducing our rate of investment. American manufacturers have enjoyed slower productivity growth than manufacturers in any of our major competitor nations, including Great Britain, over the past 15 years. The figure also shows a strong association between rates of growth and increases in capital labor ratios.

Figure 7
Growth Rate in Productivity and Capital-Labor Ratio in Manufacturing (1970-1986)



Source: "Presentation on Competitiveness."

We conclude by summarizing our policy recommendations in this area:

- *Bringing federal budget deficits under control should be the overriding priority of national economic policy. Reduced budget deficits and increased national saving are essential if American competitiveness problems are to be resolved. This will require spending cuts in areas of the budget like Social Security that have heretofore been viewed as sacrosanct, as well as significant increases in federal tax collections. In the short run, various excise taxes could generate significant increases in federal revenues, but in the long run, consideration should be given to new national consumption taxes.*
- *Structural tax policies should be redirected towards the goals of promoting saving and investment rather than consumption. From this perspective, the 1986 Tax Reform Act was in important respects a step backwards. Serious consideration should be given to restoring the investment tax credit, perhaps on an incremental basis. A crucial long-run policy priority is finding ways to raise the anemic American private saving rate.*

III. EXCHANGE RATE ISSUES

This section examines the relationship between exchange rate policies and the health of the manufacturing sector. Two separate lines of argument against policy proposals to stabilize exchange rates at current levels are presented. First, exchange rate movements—given unit labor costs here and abroad—affect competitiveness and hence sales, profitability and employment in the manufacturing sector. Adjustment to exchange rate changes is an important strategic decision for firms who have to decide whether to sacrifice export profits or market share when domestic exchange rates appreciate. We comment on this range of issues especially in the context of Japanese strategic pricing decisions that have caused American import prices to move only moderately as the dollar has depreciated.

Second, exchange rates must be allowed to decline as budget deficits are reduced if the American economy is to encounter a “soft” rather than a “hard” landing. While trade imbalances can be financed by international borrowing for a time, there comes a day of reckoning. One risk is that as in Latin America, there will be a sudden and unexpected period of credit rationing, leading to a collapse of the dollar that forces policy makers to sharply increase interest rates and throw the economy into recession. Manufacturing would be especially hard hit because of its cyclical sensitivity.

Exchange Rates and Manufacturing Profitability

When international capital flows, in response to interest differentials or expectations, exchange rates move. This affects competitiveness and disturbs price-cost relations in all markets exposed to world trade. Thus, in 1980-85 when the dollar appreciated by more than 50 percent against the currencies of our main trading partners, foreign firms reduced the dollar prices at which they sold in the U.S. market and U.S. firms had difficulty selling abroad at unchanged prices in dollars. Our exporting firms had to choose whether to cover costs, raising prices in foreign currency and thus losing market share, or keeping foreign currency prices unchanged and accept much smaller (or even negative) profit margins.

For manufacturing the exchange rate experience of 1980-85, and the partial correction in 1985-87, has been an extraordinary experience. The exchange rate became the chief variable in determining business success, not productivity, marketing, and quality, factors under management control. With their success or failure mandated by factors beyond their control, the frustration of the business community in recent years is understandable.

Table 18
Unit Labor Costs in Manufacturing,
(1979 = 100, U.S. Dollar Basis)

	U.S.	Japan	Germany
1979	100	100	100
1985	124	86	73
1986	123	123	102

Source: U.S. Dept. of Labor

Table 18 shows that in 1980-85 foreign firms enjoyed a sharp reduction in their cost basis (in dollars) thus placing them in an extraordinary position to compete in the U.S. market. Since early 1985 dollar depreciation has gone some distance to undo the artificial loss in competitiveness, although as we will argue below, the dollar has not yet declined far enough to fully restore American competitiveness.

Although exchange rate movements shift unit labor costs measured on a dollar basis, the step from there to changes in competitiveness and changes in trade flows is not automatic for several reasons. First the broad index of unit labor costs need not be representative of the unit labor cost experience in the traded goods sector. Firms that are put at an advantage by depreciation may make wage settlements above the national average and conversely, firms that are pressured by foreign competition as a result of appreciation may trim costs by denying wage increases at the national level. They may also be literally forced into achieving unusually high rates of productivity growth. These deviations from national averages do not, however, fully offset the broad swings in competitiveness indicated in Table 18. They merely mitigate them.

The second slippage between shifts in unit labor cost brought about by exchange rate movements and changes in competitiveness comes from the cost of materials and intermediate goods. In the U.S. in 1980-85 falling commodity prices in dollars dampened the loss in competitiveness and at present, with rising commodity prices, the gain in competitiveness is more limited than exchange rate movements suggest.

The third factor which has become quite important, at least in the Japanese experience, is the possibility of shifting sourcing of intermediate goods to much lower cost NICs. Such a policy can in principle offset much of the impact of a major currency appreciation. It helps at the same time to put pressure on local suppliers to grant major price concessions.

The extent of these three elements of cost reduction can be judged from data developed from a sample of more than 400,000 Japanese firms and shown in Table 19.

Table 19
Price and Cost Adjustment in
Japanese Manufacturing (percent)

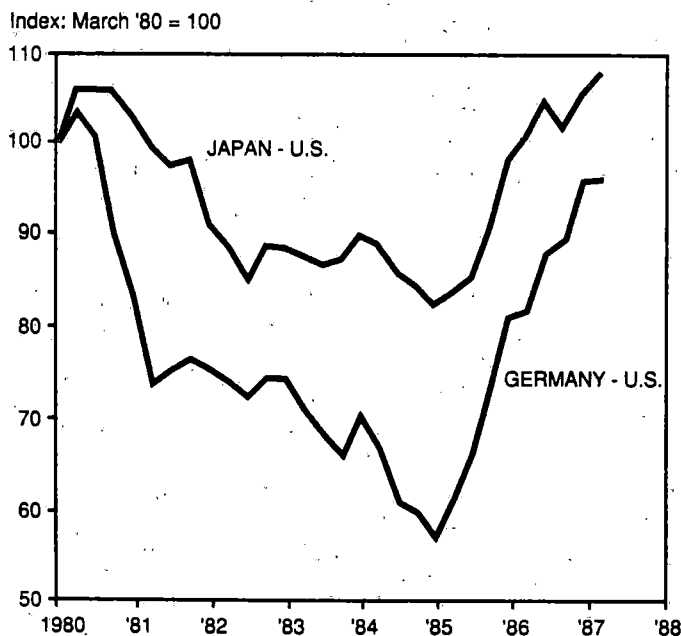
	Japanese Manufacturing			Japanese Exports	
	Costs in Yen	Prices in Yen		Prices in \$ US	Prices Yen/\$
		Domestic	Export		
1984	1.3	0.2	0	-7.3	8.4
1985	-3.0	-2.5	-1.4	23.9	-20.3
1986	-10.4	-7.4	-14.5	6.9	-20.0

Source: Wakasugi (1987)

First note that Table 19 shows significant cost reductions in Yen in 1985-86. These are due to reduced costs of labor, capital and especially intermediate inputs. Prices of manufactured goods in the Japanese markets declined in Yen by more than 7 percent, but Japanese export prices of manufactures declined by twice that amount. Thus in the export sector firms were willing to trim profit margins severely in order to maintain their market shares.

Figure 8 shows export prices in dollars of the U.S. with those of Germany and of Japan. These bilateral comparisons reveal that competitiveness as measured by the index of relative export prices moved by far less than the exchange rate, especially in the case of Japan. For the period 1980-85 the yen appreciated by 45 percent but the index of relative export prices changed by less than 20 percent. The various factors noted above, especially cost management and strategic pricing explain the lack of a very tight relationship.

Figure 8
Relative Export Price



Interestingly, the extent to which Japanese firms price to the market depends on the industry. Table 20 reports the pass through of exchange rate changes to dollar export prices for a variety of goods. For industries where worldwide competition is very intense, as for example in iron and steel or color TVs, there is relatively little pass through. But in sectors where Japanese firms can expect not to lose market share as significantly as a result of price increases, the pass through is much greater. The average—59.2 percent—tells us that there is considerable slippage between exchange rate movements and shifts in competitiveness.

Table 20
Japanese Pass Through of
Exchange Rate Changes^a (Percent)

Average	59.2	Metal Formation Mach.	50.4
Iron & Steel	13.7	Color TV	37.7
Chemicals	35.6	Passenger Cars	57.7
Information Machinery	43.7	Copy Machines	75.3

^aPercent Change in \$ export price as a ratio of the percent \$ depreciation

Source: Wakasugi (1987)

Even though slippage exists Figure 8 above does show that large swings of exchange rates, as in 1980-85 and 1985-87 bring with them a significant impact on competitiveness. The pattern of the bilateral competitiveness measure mirrors the timing of dollar appreciation and dollar depreciation.

With this background on exchange rates and price competitiveness in mind, what should be the attitude of manufacturers toward exchange rate movements? Quite unambiguously, dollar depreciation not offset by domestic wage and price inflation is beneficial. It places U.S. based manufacturers on a better footing to compete in the U.S. market and in markets abroad. By contrast, dollar appreciation, even if it reduces inflation and contains wage pressure, as was the case in 1980-85, is immensely damaging. There is accordingly an immediate, obvious and strong link between exchange rate movements and manufacturing prosperity. The one thing American manufacturing does not need is a "strong dollar".

The Problem of Postponing Adjustment

At present, after five years of economic expansion, the U.S. economy is very close to full employment with an unemployment rate below six percent. But, as we have already stressed, the United States continues to run large budget and trade deficits. Figure 9 shows the nominal external deficit as a fraction of nominal GNP, and Figure 10 shows net exports in constant dollar, again as a fraction of GNP. Both Figures leave no doubt that the trade deficit

remains far from full and early correction. In addition to the direct impact on manufacturers, a large and ongoing trade deficit risks serious general economic problems.

Figure 9
The U.S. External Deficit

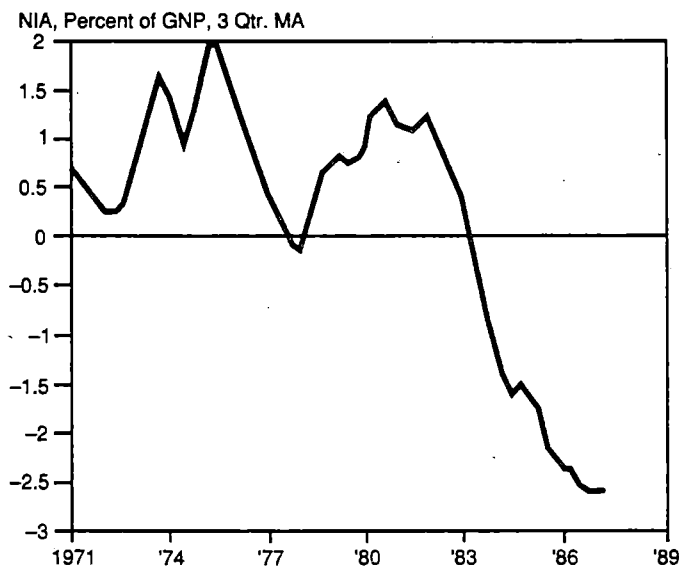
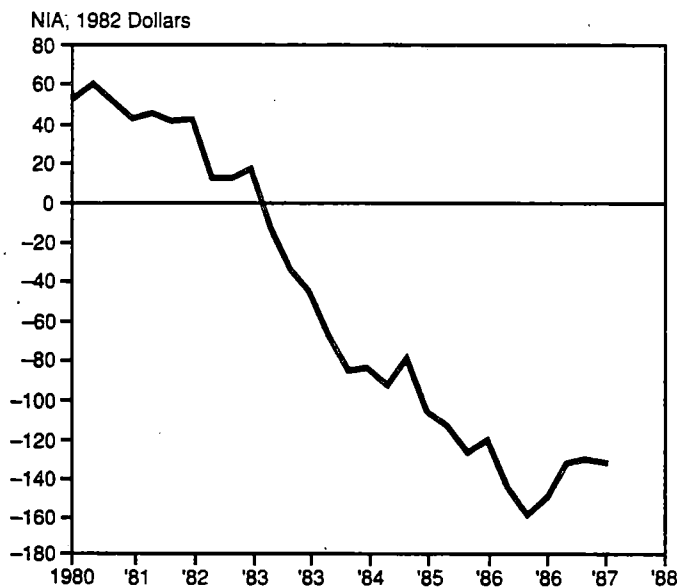


Figure 10
Net Exports



The concern is that if the deficit does not get eliminated by an early increase in the saving rate and a real depreciation of the dollar the growing imbalance and external debt accumulation may get out of control. The realistic possibility arises that after years of borrowing abroad, further borrowing could suddenly become impossible because of a loss of confidence. At that stage the dollar could collapse with a strong inflationary impact.

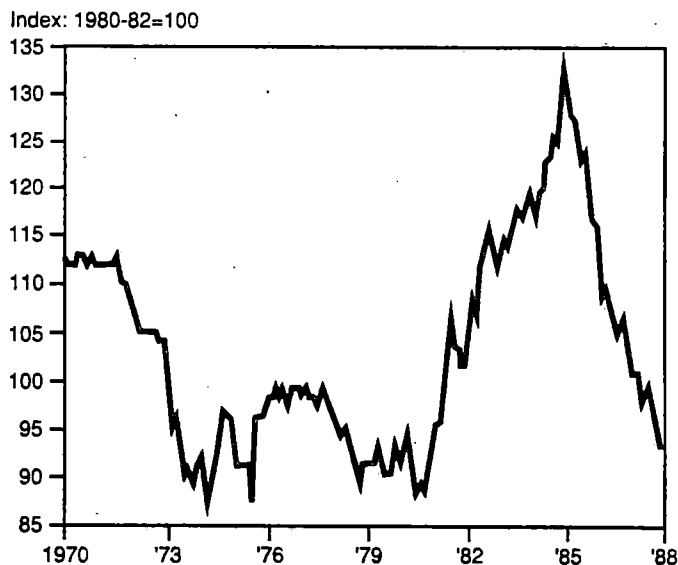
The Federal Reserve might be forced into raising interest rates sharply to stop the plunging dollar. A recession would be inevitable.

Today such a course is avoidable, if budget deficit correction takes place and further exchange depreciation is allowed. However, absent implementation of adjustment measures now, a confidence crisis some years down the road becomes increasingly likely. In an atmosphere of uncontrolled crisis, adjustment becomes infinitely harder and more painful.

Diagnosis of the U.S. International Trade Position

We have already discussed the measures that are necessary if the budget deficit is to be reduced. We now turn to why further dollar depreciation is a necessary part of the adjustment process. The decline of the dollar through the spring of 1987 has brought the level of the U.S. real exchange rate back to the level of 1980, as shown in Figure 11.

Figure 11
U.S. Real Exchange Rate



Note: The real exchange rate is the relative wholesale price of nonfood manufactures. Source: Morgan Guaranty

At that time the U.S. was roughly in external balance. Can we expect that the depreciation of the past two years will, when all the lags have played themselves out, bring U.S. trade into balance? The answer is almost certainly no for the following reasons:

- *There has been a permanent decline in agricultural prices which hurts export revenues.*
- *The differential in demand growth between the U.S. and other industrial countries amounted to more than ten percent. There is no prospect of an early reversal of this pattern.*

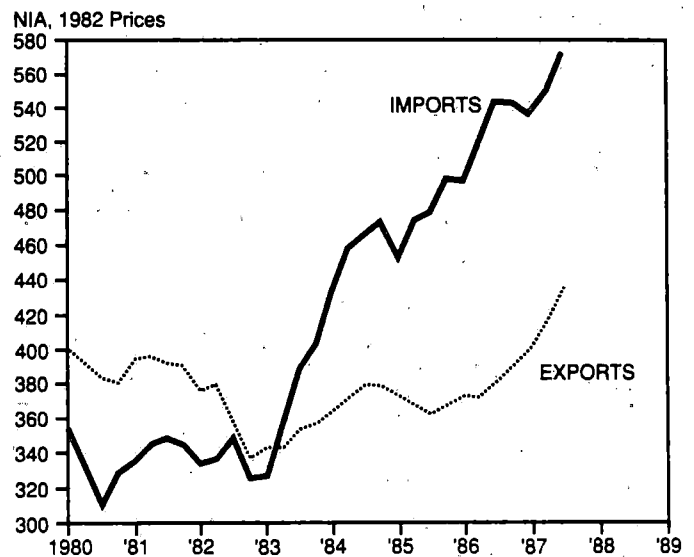
- In 1980 Latin debtor countries were borrowing and spending; today they are paying interest by earning export revenues, chiefly in the U.S. market.
- In 1980 the U.S. was a net creditor. Today the country is already a net debtor and that position will be deteriorating at a rate of \$100 billion a year or more. Increasing external debt will cumulate with interest so that ultimately a trade surplus, Latin American-style, is needed to pay the interest bill.
- The protracted overvaluation brought foreign firms into the U.S. market and dislocated U.S. firms abroad. These developments are not easily reversed particularly when the overvaluation of 1980-85 merely accelerated entry of competitors into traditional U.S. markets which otherwise would have occurred sometime later.
- The NICs have established themselves in wide-open U.S. markets. Given the growth rates of their exports the 7 year span of time since 1980 has made a dramatic difference to the U.S. trade balance.

These various factors, each negative, create a strong presumption that the U.S. external balance will not come nearly into balance at current exchange rates. Of course, adjustment lags are significant. The depreciation of 1985-87 will take at least a year to fully work itself out. However, all forecasts from econometric models predict that the U.S. deficit in the current account, at the current real exchange rate and given broadly equal growth rates of demand in the industrial countries, will not even fall to \$100 billion. The most recent forecast of the OECD places the 1988 U.S. trade deficit at more than \$120 billion. If exchange rates remain stable, the current account deficit will actually rise thereafter.

The argument that further depreciation is required to balance the current account is often countered with the charge that depreciation does not work—witness the failure of the trade balance to improve. There is not much substance to the argument: as we saw above, exchange rate movements do not translate into one-for-one changes in competitiveness, but there is also no evidence whatsoever that they are fully offset by cuts in profit margins and cost reductions. Moreover, given the large profit margins accumulated in 1980-85, while the dollar became increasingly overvalued, it is not surprising that foreign firms were able to avoid one for one prices increases in the first round of depreciation.

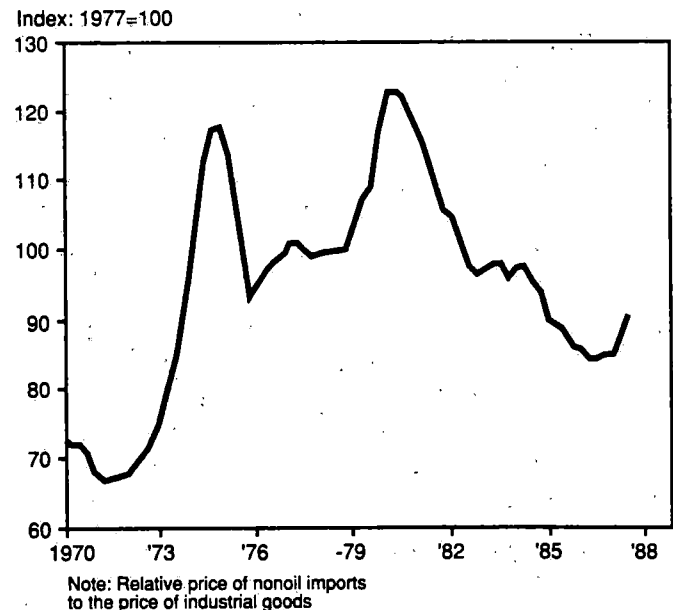
The same resistance will not be possible as the dollar declines further. On the contrary, dollar depreciation will become increasingly effective. This is clearly shown in Figure 12.

Figure 12
Real Exports and Imports



Contrasting with the favorable development of export volume, there has been continued growth in import volumes, depreciation notwithstanding. The reason can be seen in Figure 13 which shows to date very little adjustment in the relative import price and as a result no significant effect on trade flows.

Figure 13
The Relative Price of Imports



Further dollar depreciation will raise the losses of foreign firms in the U.S. market to such extremes that they will cave in and raise prices. At that point trade flows will start reacting. The sooner and stronger the adjustment of the dollar, the more rapidly U.S. manufacturers can begin replacing imports in the home market.

Before considering how much further the dollar needs to fall to close the external balance gap, we briefly explore the view that there is no need for active concern about the level of the dollar.

Why the Dollar Might Have Depreciated Enough

Most observers who feel that the dollar now is correctly valued place their confidence in one of two arguments. Either they argue that adjustment lags to the depreciation of the past two years are long and that patience is required to await the full benefits. Or else they believe that there is basically no need for U.S. current account balance because deficits can be financed almost indefinitely.

As we have seen, the adjustment lag argument does not stand up to scrutiny. All available evidence on adjustment lags indicates that they are present and, adjustment to exchange rate changes only occurs gradually. But the available evidence is also unanimous in suggesting that after all adjustments have occurred there remains a very sizeable deficit—at least \$100 billion by 1990. Only if the rest of the world experienced a major spurt in demand could the gap be closed at the current level of the dollar. Of course such a spurt is quite unlikely.

A different argument holds that the U.S. does not really need to adjust because deficits can be financed for a very long period. This argument is based on the notion that the U.S. has an almost unlimited ability to finance current account imbalances by selling off assets. It is true that the rest of the world holds even now a small share of its portfolio in the form of U.S. assets. Therefore, there is a large pool of saving from all industrialized countries available to finance a continuation of the deficit even at \$100 billion levels. Just as a country with a terms of trade improvement can spend the extra real income without impairing its creditworthiness so can the U.S. spend the rents that flow from the attractiveness of its assets.

If the world economy had newly discovered U.S. assets, and if as a result there were massive capital gains, U.S. residents could spend some of that increased wealth. The question is, however, what happens when the capital gains run out. Krugman and Hatsopoulos (1987) have raised exactly that question, and they conclude that concern over the long run outcome of the deficits is urgent:

“The U.S. compensated for its manufacturing deficit, not by selling more of something else, but by running down its overseas investments and by borrowing from foreigners. This can go on for years,

but not indefinitely . . . within a decade the ratio of debt to GNP would be as high as that of Brazil and a major concern. This is not a feasible outcome. Sooner or later a reluctance of foreigners to continue to rapidly increase their holdings of U.S. debt instruments will force a decline in the dollar large enough to enable U.S. firms to sell on world markets . . . Doesn't this mean that worries about the manufacturing sector are therefore misplaced? The answer is no . . . The longer-term issues of U.S. performance in manufacturing will reinforce these costs. Because of U.S. problems with productivity, technology, and quality, in order to balance U.S. manufactures trade, the dollar must fall relative to other currencies substantially below historical levels. Exacerbating this problem will be the damage done to U.S. market position by the sustained strength of the dollar”.

International skepticism about the U.S. ability to adjust is already keeping private savers abroad from further accumulation of dollar assets. Today it is primarily central banks who are financing the external imbalances in an effort to “keep the dollar up.” One can understand the interest of Germany and Japan in sustaining an overpriced dollar, but it is hard to understand why the Federal Reserve should collaborate with high interest rates and intervention.

Policy Towards the Dollar

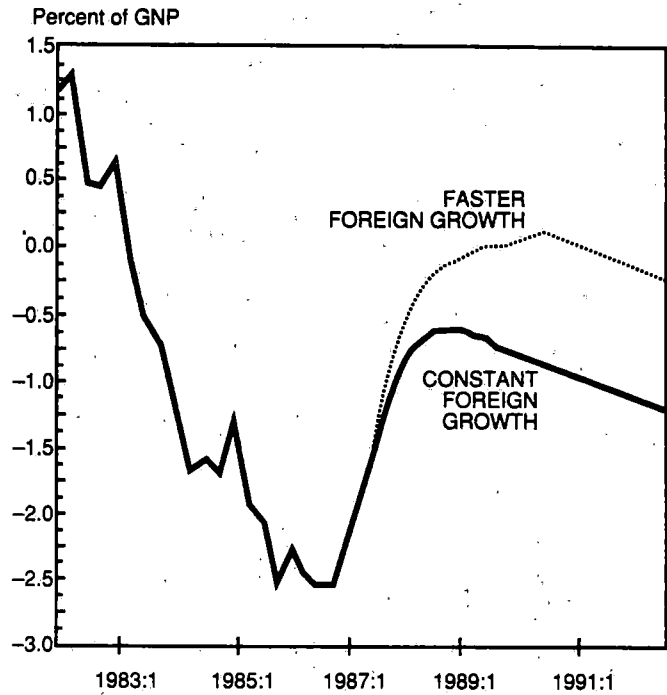
Just how much of a dollar decline is required depends on what level of sustained deficit is acceptable and on what is assumed about relative growth rates of spending here and abroad. We are not aware of any forecasts of the U.S. external balance that predict reductions of the deficit to near zero levels at the current level of the dollar. Estimates of the likely deficit by 1990 differ widely, but all estimates have in common the snowballing effect of deficits on debt, interest payments and hence future deficits. The rapidly growing interest burden implies that the noninterest part of the current account will have to show ever larger improvement to balance the growing interest charges. For that, a further depreciated dollar is necessary the longer the adjustment is postponed.

Estimates of the size of the required adjustment of the dollar range widely. Recent statements by a group of experts assembled by the Institute of International Economics came out with a low estimate of only 10 to 20 percent. But this estimate came in a context of a major adjustment in spending growth in Europe and Japan with complementary policies in some South East Asian NICs. Other estimates assume that spending growth here and abroad proceeds exactly at the same rate. In that case a much higher real depreciation of 30 percent would be

required to eliminate the noninterest deficit in the external balance. A realistic scenario might lie between these two with some increase in the growth rate of spending abroad and some decline (due to budget correction) at home. In that setting a 15 percent real depreciation of the dollar against all American trading partners might be necessary. Since countries including Canada, Latin America and some countries in South East Asia that have tied their currencies to the dollar account for close to half of US trade the remaining currencies such as the Deutsche Mark and the Yen have to appreciate by far more than 15 percent. In this sense, a rate of 100 Yen/\$ is not at all implausible.

Sometimes it is suggested that growth in foreign demand can bring about a balance in US trade without any need for further dollar depreciation. This is not realistic (see Figure 14). Unless the rest of the world increases spending growth by significantly more than 2 percent for a number of years, shifts in spending growth here and abroad by themselves cannot balance our trade accounts. Too much of the extra foreign spending falls on their goods, not ours and too much of our budget reduction is reflected in reduced demand for U.S. goods rather than in an improvement of the trade balance. Thus a gain in competitiveness is required to complement spending adjustments, shifting world demand toward U.S. goods.

Figure 14
U.S. Net Exports 1982:4-1986:4
and Forecasts under Alternative Foreign Growth Rates,
1982:1-1992:4



In the discussion about the need for further dollar depreciation it is frequently argued, especially by our trading partners, that budget correction, not dollar depreciation is the answer. They do not say outright that we should solve our problem by a recession, but this is where their logic points. If reductions in budget deficits do not operate on the trade deficit by reducing exchange rates, they can only work by reducing domestic incomes. This means recession.

U.S. budget correction is certain to make some contribution to balancing trade. But the trade deficit will not disappear as a by-product of U.S. budget correction. Increased taxes and expenditure cuts will surely improve the external balance. But budget cuts reduce all spending, including domestic goods. As a result there will be an increase in unemployment unless a gain in competitiveness creates an offsetting increase in net exports. This is precisely the stage where monetary policy comes to play its role. Easing monetary policy to sustain growth in the face of budget cuts assures that part of the adjustment takes place via dollar depreciation and increased net exports.

Should the U.S. actively seek or prevent movements in the dollar? Our view is that a hands off policy is far preferred, given the present uncertainties about equilibrium exchange rates, to any attempt to fix the dollar in a new exchange rate agreement. The U.S. would run the serious risk of having to defend an overvalued dollar by

high interest rates—thus hurting investment, growth and even the budget—if rates were fixed near the current levels. There may well be a case for returning to more fixed rates once the large imbalances in the world economy are trimmed, but this is clearly not the time.

The right dollar policy is essentially one of not intervening, except to the extent of smoothing short run excessive fluctuations. Once the budget deficit is cut (or expected to be cut) easier monetary policy can afford to support growth without risking much higher inflation. Easier monetary policy would almost certainly lower the value of the dollar and thus make manufacturing more competitive. In that way full employment can be sustained in the difficult phase of a major fiscal contraction.

There are costs and benefits to a dollar decline. In the United States it is tempting to forego further dollar depreciation on the argument that this would spare us the risk of higher inflation. Further dollar depreciation, and full price adjustments to the past depreciation which have not yet occurred, will surely bring more inflation. But that is an unavoidable adjustment required to restore our competitiveness. We can postpone that inflation, but only at the cost of a much larger and more painful adjustment later. The choice is not between depreciation or no depreciation, but rather between a soft landing and a hard landing. For manufacturing, and for the entire economy, the soft landing option is by far preferred.

We conclude this section by summarizing our policy recommendations:

- *Efforts to stabilize exchange rates at current levels are misguided. They run very serious risks of throwing the economy into recession and make an eventual financial collapse more likely. American monetary policy should be directed at insuring continued economic growth as the budget deficit declines, not at arbitrary exchange rate targets. Policymakers should recognize that a continued dollar decline is both likely and desirable.*
- *Rapid growth in the world economy and the expanding markets that it brings about are crucial to the health of the manufacturing sector. As the United States brings its current account back into balance, it should encourage other nations to stimulate domestic demand to replace export demand.*

IV. THE NICS, PROTECTION AND FOREIGN DIRECT INVESTMENT IN THE U.S.

The previous discussion has focused on exchange rates as an important part in the adjustment process that corrects the budget and trade deficit. In this section we explore three related policy issues that arise in a longer term context of structural change; the challenge posed by the newly industrialized countries (NICs), questions of domestic protection, and the role of foreign investment in the U.S. economy.

U.S. trade policy has gone in opposing directions in the past twenty years. Tariff reductions have meant increasing trade liberalization, while trade has increasingly been restricted in areas where U.S. producers showed special vulnerability. The form these trade restrictions have taken—quotas (QRs) and voluntary export restraints (VERs), non-tariff barriers (NTBs) and orderly marketing arrangements (OMAs)—make them especially costly in terms of resource allocation and hence particularly undesirable. The extent of these restrictions can be judged from the World Bank's claim in its 1987 Report that about 15 percent of U.S. imports are covered by "hard core NTBs."

Moreover, these administrative restrictions on trade are widening in scope. In the 1960s they applied mostly to textiles and apparel and to particular agricultural goods. Today microchips, steel, automobiles and a large range of manufactures of special interest to developing countries already fall into the categories subject to administrative trade decisions. The World Bank's index of trade restriction, which measures particularly the impact of non-tariff barriers, has increased from 100 in 1981 to 123 in 1986. This increase in protectionism by the U.S. exceeds that in any other industrialized country. We argue that it is essential that this trend be stopped. To the degree there is protection, it should be exercised in a more cost-effective form and protection itself should be reassessed and hopefully reversed.

In the past ten years the newly industrialized countries (NICs) have been emerging as a major factor in U.S. trade. Their competitiveness has invited a number of responses: to take advantage by importing components from these countries or locating production there; to seek protection by quotas or voluntary export restraint; or to assume the problem away or belittle it. We will argue that manufacturing cannot afford to disregard the growing role and opportunity presented by the appearance of the NICs as competitive production centers. We advocate that taking advantage of the opportunities is a far better response than seeking protection. Our recommendation is that manufacturers should seek to influence policy in the direction of securing market opening in these countries, including free trade areas with Mexico, Brazil and Korea rather than trade restrictions.

An outward looking manufacturing sector, which is the appropriate perspective in the context of trade balancing and rising competitiveness, cannot afford to take a narrow view of foreign investment in the U.S. Of course, foreign investment here means competition for managers, but it also means good jobs and increased manufacturing activity. We therefore urge a very open policy toward direct foreign investment in the U.S., just as we have been urging such a policy on Canada or Mexico.

The Emerging Role of the NICs in U.S. Trade

The emergence of the newly industrialized countries (NICs)—countries like Korea or Brazil, Mexico and Taiwan—as major world suppliers of manufactures is even today underestimated. It helps to remember the role of Japan in world trade only thirty years ago. In 1955 Japan's share in world exports was only 2.3 percent while today it is more than 10 percent. From producing "cheap" goods for exports Japan has moved to become the leading world trader. The progress of the NICs is no less spectacular. In 1963 they accounted for 4.3 percent of world exports of manufactures, in 1973 for 6.9 percent and already for 12.4 percent in 1985.

Table 22 shows U.S. trade with all developing countries. Note in particular the \$50 billion deterioration in our manufacturing trade balance with these countries. And their export boom is only starting. Mexico's manufactures exports last year grew by 48 percent, Korea recorded export growth of manufactures (other than ships) of 33 percent. These are not trend growth rates, but every year a few NICS manage trade expansion at these rates and the others enjoy export growth rates of at least 10 percent on average. Table 23 shows that in U.S. manufactures imports developing countries today have a share nearly equal to that of Japan. Moreover, their role is not only apparent in textiles and clothing where low wage, unskilled labor can be expected to have an edge, but increasingly in engineering goods and household appliances.

Table 22
U.S. Manufactures Trade
With Developing Countries (Billion \$)

	Imports	Exports	Balance
1980	29.5	55.6	26.1
1981	35.1	61.5	26.4
1985	65.5	46.0	-19.5
1986	77.3	49.4	-27.9

Source: GATT and U.S. Department of Commerce

Table 23
Share of Japan and
Developing Countries in U.S. Imports

	Japan		Developing Countries	
	1973	1985	1973	1985
All Imports	14.7	20.2	29.9	34.0
Manufactures	22.0	27.9	17.4	26.0
Textiles & Clothing	14.5	6.0	56.0	68.2
Engineering Products	36.9	37.9	10.1	18.1
Household Appliances	52.7	59.6	23.7	30.9

Source: GATT

Even in the area of capital goods import substitution is taking place in the NICs and their exports are now starting to appear. The NIC's exports are no longer textiles or rubber footwear. On the contrary, the NICs are now producing consumer durables with their own brand product names. Korean producers, for example, now prefer to market "Leading Edge" computers or "Hyundai" cars under Korean new and untested brand names rather than be satisfied to produce and sell anonymously through U.S. or Japanese distributors under their established brand names. This new strategy, of course, diverts a significantly larger share of oligopolistic profits toward the Korean producers. The strategy also reflects an extraordinary confidence that the developed countries should worry about. This is all the more the case in that South East Asian NICs believe their export success reflects not only price but even more so quality performance.

The dramatic increase in the trade potential of the NICs has become particularly clear in the aftermath of dollar depreciation. The NICs turned out to be sufficiently competitive suppliers of components so that Japanese firms, by simply shifting their sourcing away from Japanese firms to Korea or to Taiwan, could make up much of their loss of export competitiveness. The combination of extraordinarily low wages (see Table 24) combined with productivity levels not far off those in industrial countries (in large part a reflection of extraordinary working hours and discipline—Koreans say the Japanese are lazy!) made these countries super competitive. More than a decade of record investment rates established the industrial capacity.

Table 24
Hourly Compensation in Manufacturing
(\$/hour at 1987 exchange rate)

United States	\$13.09	Korea	\$1.68
Germany	16.00	Taiwan	2.08
Japan	10.94	Singapore	2.51
France	11.89		
United Kingdom	8.19		

Note: The data refer to all of manufacturing. They represent 1986 levels of hourly compensation evaluated at June 1987 exchange rates.

Source: U.S. Department of Labor

It is tempting to down play these developments arguing that the share of the NICs in world trade is small and that even at high growth rates they present no near term problem. But that would be as much of a mistake as to have misunderstood the inevitable rise of Japan over the past twenty years.

Three arguments have been used to minimize the role of the NICs for an importing country like the United States. First, it is suggested that the share in imports from the NICs is so small that even with high growth rates there is no serious threat. The argument is clearly wrong in that high growth rates persisting for a number of years simply alter the landscape. By 1987 the NICs represented a significant factor in trade problems and trade policy for the U.S.

The second argument that is advanced is that the NICs will spend their export revenues on extra imports. This argument is unsatisfactory. The NICs have high saving rates and not all of their extra saving necessarily translates into increased spending and hence increases in imports. Part of their income may be used to pay off debts with trade surpluses, such as Korea is doing now or Mexico, or they may use the income from strong export growth to invest abroad or add, like Taiwan, to their reserves. Whatever they do, there is no automatic mechanism that translates extra exports into extra imports. But even if all the extra exports were spent on imports we may still face a situation of triangular trade: the NICs export to the U.S.A. and use the export proceeds to buy from Japan. And then Japan does the saving and investing in the United States. Thus, one way or another an export drive by the NICs may displace U.S. production in manufacturing.

The third argument that is used to minimize concerns about the NICs is made on the basis of productivity. Recognizing that wages are extremely low in the NICs, it is argued that the low wage reflects low labor productivity and hence is not a threat to U.S. manufacturing. But that argument no longer holds true. In many activities labor in the NICs, certainly in Southeast Asia, is not significantly less productive than is U.S. labor. Accordingly the wage differential represents a massive competitive advantage for

labor intensive activities. The ease and speed with which technology and physical capital can move today enhances the ability of firms to shop worldwide for favorable locations.

An example may serve to highlight just how powerful this new competition can in fact turn out. In a study entitled Automation and Global Production Shaiken and Herzenberg of the University of California in San Diego report on the relative costs of car engine plants of a U.S. firm located in Mexico and in the U.S. The Mexican firm was staffed by labor without prior work experience. The authors summarize their findings as follows:

“... the Mexican plant achieved comparable machine efficiency, labor productivity, and quality to the U.S. plant within its first two and one half years of operation. Comparable does not mean equal. On some production operations the Mexican plant was more advanced, on others it was less efficient. Overall, the Mexican plant achieved 80 percent of the machine efficiency of the U.S. plant, 75 percent of its labor productivity, and a quality rating somewhere between the two North American plants. A major advantage for the Mexican plant is a wage less than 10 percent that of the U.S. plant.”

It is clear that for very capital intensive processes requiring high skill labor the U.S., Europe or Japan remain perfectly viable locations. But for processes that have a significant labor share—say more than 20-30 percent—we should expect very rapid phasing out of U.S. locations. Automation, of course, moves in the direction of maintaining the viability of a U.S. location, but that applies to production, not to employment.

The NICs pose very delicate problems for US trade policy. To the extent that they produce components they compete directly with U.S. suppliers of components and as such their competition is a source of friction. But recourse to low cost components or intermediate goods from the NICs is an important means of sustaining the competitiveness of U.S. produced final goods. Denying access to intermediate goods from the NICs would raise the cost of U.S. production and hence leave us less competitive in our confrontation with other industrialized countries. Thus it is especially important to stave off protection in this field. Of course, that does not imply that we should not take an interest in trade and exchange rate policies of the NICs.

We have argued above that the authorities should basically abstain from manipulating the dollar, allowing market forces to set exchange rates. But what about the currencies of Korea or Mexico or Taiwan which are fixed to the dollar? If these countries follow the dollar in a decline our gain in competitiveness would be diminished. Indeed, as we noted above, Japan might maintain competitiveness of final goods by increasingly shifting the sourcing of

components to these countries. Given current trade patterns in the world economy and the likely further decline in the value of the dollar, it would be highly desirable for Korea and Taiwan to peg their currencies to a currency basket in which the yen had significant weight rather than merely to the dollar.

Trade policies probably have the potential to have a longer lasting impact on our trade relation with developing countries than do exchange rate policies. Most developing countries continue to restrict imports of a wide range of manufactured goods, services and agricultural goods. Forcing appreciation on these countries may simply mean that we will buy from Japan what we bought before from Korea or Taiwan. It would be much better for American policy to concentrate on gaining market access and hence increased exports.

Indeed, it may be worth considering bilateral free trade agreements with major NICs such as Mexico, Brazil or Korea where the large (and protected) emerging markets offer a very attractive opportunity for U.S. manufacturing. The argument that the United States should seek free trade arrangements with countries like Brazil, Mexico or Korea seems at first sight far fetched. But the example of Europe surely highlights the extraordinary gains to be reaped from a trading area. Moreover, Europe has been expanding and closing. New members have joined—most recently Greece, Spain and Portugal. Turkey and North Africa are already opening discussions for membership. For the United States this expansion of the European Common Market is an adverse development. It means European firms will increasingly displace U.S. exports in their own markets. This development will be strongly reinforced with the creation of the full-fledged “internal market,” i.e. the removal of all forms of trade impediment.

While the U.S. must expect to lose market share in Europe a similar development is occurring in the markets of developing countries. Japan is increasingly replacing the United States as a supplier of technology and manufactures. Part of the deterioration in U.S. performance is certainly explained by the strong dollar. But in part the Japanese performance reflects a conscious effort to cultivate expanding markets of the future by hardnosed, far-sighted investment strategies. Table 25 compares the changing trade performance of the U.S. and Japan.

Table 25
Share of Total Imports
from the United States and from Japan

	All Developing Countries		Korea	
	1980	1986	1980	1986
U.S.	15.7	14.3	22.2	20.2
Japan	10.0	13.7	26.6	33.3

Source: IMF

A policy of free trade areas with selected, major developing countries would be a dramatic step to open these markets to U.S. exports on a preferential basis. There are a number of advantages. First and foremost, the policy would ensure that U.S. exporters get ahead of Japanese firms in entering these markets which at present are semi-closed. Second, there would be a lasting offset to the shrinking or closing of the European market. Third, we would have more leeway in accepting goods from developing countries if at the same time we can assure that trade is a two-way street.

Of course, there are also political costs to a free trade arrangement. We could no longer restrict imports from our partners in sensitive areas such as steel or automobiles. That may ultimately be an advantage, since as we noted above, these trade restrictions are very costly. On strictly economic grounds it is difficult to believe that the U.S. would not achieve major gains from such a forward looking trade policy.

Trade Policy

In the past few years, in large measure as a result of dollar overvaluation, the U.S. has seen a sharp reemergence of protectionist sentiment. The proposed local content bill was one piece of very protectionist legislation, and so was the Gephardt amendment. Manufacturing has regrettably not taken a strong stand against protection. But it is not difficult to recognize that all of manufacturing cannot gain from protection. Firms who do not have any engagement in international trade would lose because they would experience a costly increase for some intermediate goods (say steel) where protection raises the domestic price. Firms who export would not only have higher costs as a result of increased prices of some intermediate goods, but they would also find quite possibly that foreign markets would be close to them in response. An import competing firm taken in isolation is right to believe that if there were substantial protection foreign competitors would be excluded. But for the manufacturing sector in the aggregate it is difficult to accept that we can exclude foreign goods without any costs.

While U.S. firms competing with imports would see an advantage in protection, national economic policy must recognize the adverse effects on exporters. The best way to deal with international competitiveness is to use the exchange rate rather than protection. Exchange depreciation works symmetrically exerting pressure on foreign firms to raise their prices in the home market and giving exporting firms a competitive edge in foreign markets. There is no reason why exporters should not also be allowed to make a contribution to and prosper from the task of closing the external balance gap. Indeed, expanding

resource utilization in the export sector may well be the most productive way of using the nation's resources.

A second crucial area for commercial policy concerns quantitative restrictions on imports and voluntary export restraints. In the past decades tariffs have been whittled down in successive rounds of international trade negotiation to relatively low levels. For most goods they no longer represent a significant obstacle to trade. Indeed, the massive dollar overvaluation of 1980-85 "liberalized" imports far beyond any protection tariffs give.

Table 26
Examples of Post-Tokyo Round Tariff Rates

	U.S.	E.C.	Japan
Food, Beverages and Tobacco	4.7	10.1	25.4
Wearing Apparel	22.7	13.4	13.8
Nonelectrical Machinery	3.3	4.4	4.4
Electrical Machinery	4.4	7.9	4.3
Transport Equipment	2.5	8.0	1.5

Source: GATT

In special areas such as textiles or food tariff protection remains important, but an indication of the low rate of tariff protection in the U.S. is the fact that tariff revenue as a fraction of dutiable imports is now only 5.5 percent. This compares with 10-20 percent in the 1950s and 1960s.

But the low tariff rates are in many areas a misleading indication of how free trade is in fact. In several areas where U.S. manufactures have felt intense import competition (steel, automobiles and many of the goods produced by the NICs) our administration has imposed quotas or urged foreign countries to administer a voluntary export restraint program. But quantitative restrictions or voluntary export restraints abroad are inefficient devices from a point of view of resource allocation and from a budgetary perspective. They create monopoly positions for domestic firms which can exploit consumers without any public benefit to match. We therefore recommend substitution of tariffs for quantitative restrictions. Tariffs leave room for competition—there is protection, but foreign firms can overcome it if they are willing to lower their prices sufficiently. At the same time the government collects revenue from the tariff and hence some contribution is made to the task of budget balancing.

In the longer run we should reexamine whether there is any ground to support differential protection beyond a moderate tariff of 5 percent or so. There is no evidence from studies of adjustment under protection that would indicate that U.S. firms in fact have emerged competitive on a scale that would reward society for the initial investment in protection.

The only economic argument for protection concerns "infant industries" where temporary protection provides the means to achieve the scale and learning by doing which

ultimately makes an industry cost competitive at the world level. Our protection is not of that variety at all. It is permanent protection for those industries that have long ceased to be competitive internationally. In such cases society should support adjustment, not subsistence. The economic costs of keeping alive inefficient industries are extremely high: David Tarr and Morris Morke of the Federal Trade Commission in a study entitled *Aggregate Costs to the United States of Tariffs and Quotas on Imports* report that the cost of U.S. protection amounts to almost \$10 billion per year. That number represents the costs to consumers of protection over and above the benefits created for firms and workers in the protected industries. In an estimate of the costs of voluntary export restraints for automobiles and of quotas for steel, to give concrete examples, the authors report the following finding:

Table 27
The Costs and Benefits of Protection
(Billion 1987 \$ unless noted)

	Automobiles	Steel
Consumers' losses from higher prices	1123	1241
U.S. Producers' Gains	130	481
Net loss to the U.S. economy	993	881
Quota Rent to foreign firms	932	629
Loss to the economy per job saved ^a	244,235	88,525
Cost Benefit Ratio ^b	21.4	24.6

^aLosses to the economy in thousand dollars per job saved.

^bLosses to the economy per dollar of earnings saved as a result of protection.

Source: Tarr and Morkre

The table makes a very simple point: protection is expensive. It is an expensive way to save jobs—the cost benefit ratio is more than 20! It is an expensive way to give firms rents and, perhaps worst, foreigners collect rents as a result of our protective policies. These rents could at least be collected by the Treasury to help balance the budget. The examples given here are by no means special or extreme. Study after study reveals that permanent protection is exceptionally expensive. Hand in hand with a sounder macroeconomic mix and a more realistic exchange rate should go a policy of reevaluating the trade regime. Free trade areas, more efficient protection and ultimately dismantling of protection all help manufacturing achieve a more cost effective resource allocation.

Direct Foreign Investment in the United States

Finally we want to touch briefly on the controversial issue of foreign investment. In the past few years foreign firms have attracted attention with their direct investment in the U.S. in the area of manufacturing. Quantitatively these investments remain very small as Table 28 brings out.

Table 28
Foreign Direct Investment
in the United States (Billion \$)

	Flows				1986 Stock
	1983	1984	1985	1986	
Total	8.1	15.2	23.1	31.5	209.3
Manufacturing	3.1	3.1	12.1	13.7	68.1
By Country:					
Japan	0.4	1.8	1.2	4.7	23.4
Europe	4.9	6.5	15.4	17.1	141.7

Source: Dept of Commerce

Employment by foreign-owned affiliates now is 3.2 million and foreign investors own 15 million acres of U.S. real estate. But even though the numbers for foreign penetration by direct investment remain moderate—certainly compared to trade penetration—the specter of increasing competition in the home market from foreign producers, even after dollar depreciation, makes domestic manufacturers apprehensive. Hence the question whether foreign investment is or is not in the national interest.

In advocating more liberal policies in developing countries we always argue that foreign investment brings benefits in the form of capital, technology and experience. The same argument applies to foreign direct investment in our own economy. If foreign firms can create high wage jobs here we should prefer that to having our manufacturing workers displaced by imports.

It is often argued that domestic firms, by relying on domestic suppliers, create more jobs than foreign firms who may use the U.S. location only as an assembly plant for foreign components. That view implicitly compares a situation of autarchy and no foreign direct investment as the alternative. But U.S. consumers will not (and should not) accept that all low cost production from abroad be excluded. A more viable strategy that does not send us on the road to increasing protection is to make the best of the international division of labor. A realistic value of the dollar assures that we are not outpriced across the board. With that safeguard we can afford to let the most efficient firms (whether "domestic" or "foreign") produce in the U.S. The most efficient firm, in the end, will create the most sustainable good job and hence will contribute best to our standard of living. There is no question that the increasing division of labor will mean more trade in intermediate goods. It would be ill-advised to bar foreign firms from establishing operations here, using at least some of the domestic resources, while bringing in some inputs from abroad.

We conclude this section with a brief summary of our main policy recommendations:

- *The newly industrialized countries pose a significant and increasing challenge to American manufacturers. Efforts to thwart the entry of their products into the United States are not likely to succeed, and if they did succeed would impose large costs on American consumers. Instead of seeking to block imports, American policy should concentrate on opening up markets for American products in the newly industrialized countries.*
- *Protectionist measures whether to limit imports or to discourage foreign direct investment in the United States should be avoided at all costs. Protection only invites retaliation. Even if there were no retaliation, protectionist policies would strengthen the dollar making US exporters less competitive. Foreign investment is likely to benefit the economy even though in some cases it will hurt entrenched American firms.*

SUMMARY

The fortunes of manufacturing and the rest of the economy are closely linked. The American economy is unlikely to succeed in meeting the twin goals of full employment and rapid living standards unless the competitiveness of the manufacturing sector is restored. Conversely, the manufacturing sector is unlikely to prosper, unless the general macroeconomic imbalances that have led to the twin budget and trade deficits of recent years are corrected.

The situation created by the macroeconomic policies of the last decade is serious. American manufacturers have lost market share in world markets while at the same time providing for only modest growth in workers' real wages and low rate of profit for shareholders. Ominously, import penetration ratios especially in capital goods industries have risen sharply. Without the major defense build-up which is now coming to an end, the manufacturing sector would have contracted significantly.

If the policy environment is not altered, the competitive problems of American manufacturing will only increase. Inadequate national saving and investment will lead to slow productivity growth. Excessive exchange rates will cause our foreign debts to mount rapidly, threatening an eventual collapse of the dollar with dire consequences for the financial system. Misguided trade policies that close markets rather than opening them risk a breakdown of the relatively free trading system that has effectively promoted prosperity for the past forty years.

Fortunately, there are constructive and feasible policy steps that can be taken to strengthen the American economy and manufacturing's role in it. There is no inherent reason why American manufacturing needs to give up its traditional preeminence. But prompt policy action is required in three areas: fiscal policy, international macroeconomic policy, and structural trade policy.

About the authors of this study:

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Rudiger W. Dornbusch holds the Ford International Professorship of Economics at Massachusetts Institute of Technology. Dornbusch is a member of the Social Science Research Council Committee on Growth and Stability and is a fellow of the American Academy of Arts and Sciences of the Econometric Society. The author and editor of numerous books and publications, he is associate editor of the Quarterly Journal of Economics. He holds a doctorate from the University of Chicago.

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Eastman Kodak Company
Communications & Public Affairs
343 State Street
Rochester, NY 14650

No faction

THE WHITE HOUSE
WASHINGTON

March 20, 1989

Dear Mr. Baruch:

Thank you for sharing your thoughts on a competitiveness theme to highlight the Administration's goals.

I will pass your ideas to our staff in the White House formulating the President's message for their consideration.

Regards,

John H. Sununu
Chief of Staff

Mr. Jordan Baruch
1200 18th Street, N.W.
Suite 610
Washington, D.C. 20036

cc: Chriss Winston w/ incoming - FYI

JORDAN BARUCH ASSOCIATES INC.

14 March 1989

Dr. John Sununu
The White House
Washington, D.C. 20500

Dear Dr. Sununu:

I take the liberty of writing to you as a fellow alumnus of MIT and former professor in NH (at both Tuck and Thayer at Dartmouth). Should you need additional information to make sure I'm not a nut, you can check with Bruce Merrifield, my successor at Commerce.

Over the next few months the President will be coming under enormous pressure to increase our "competitiveness". He is also going to be pulled into the debate on High Definition T.V. (HDTV). In addition, the administration is likely to get a lot of garbage about not having national goals or visions of the future. I'd like to suggest a possible program that can, I think, address all three of the above points. I've phrased it as a Presidential Announcement (akin to John Kennedy's "Man on the moon in this decade).

Presidential Announcement

When President Kennedy announced, as a national goal, putting a man on the moon within the decade, he set us a task that caught the imagination of the country and one at which we succeeded. That task, however, did not directly address the needs we had then -- and have now -- for a greater civilian technology, education for our young and a continuing, growing competitive position in world commerce. Some of its developments did, of course, impact those needs but only peripherally to the central goal. Today, I am announcing a national goal that will directly impact our people's well being.

By the year 2000, this nation will develop a telecommunication system that will provide a Window On the World affordable by every school, by publicly accessible community centers, libraries and even homes.

Rather than pursue the course toward High Definition Television being taken in Europe and Japan, we will pursue an overall system that links our capabilities in fiber-optics and satellite transmission, our skills in educational and entertainment software creation. our experience in the construction of open-architecture computers and mass storage devices and our enormous and growing store of machine-accessible knowledge.

The Window On the World will bring to the lay user both ordinary television programs and those with which he or she can interact -- taking the roles of detective or astronaut or explorer. It will bring whole new educational experiences, in and out of school -- such as those being developed at MIT's project Athena to students from grade school to graduate school. Doctors, lawyers, accountants, astrophysicists and grocers will use it to organize and exchange their knowledge with each other and with their clients. Broadcasters will have the opportunity to develop whole new forms of programs, educational publishing will take on a new meaning. Indeed, since the Window On the World will be an open-architecture system -- with many manufacturers able to enhance its abilities, it will become a totally new form of communication and information use for lay users and professionals alike.

To secure that goal will require a common commitment among many parts of the private sector. Computer companies and universities, communication firms and teachers, chip manufacturers and broadcasters, writers and artists and many more will find their capabilities pulled by the demands on the system. In government, the National Science Foundation, NOAA, Commerce, the Department of Defense and other agencies will develop action programs in support of this goal under the coordination of my Science Advisor and the OMB. We will get it done.

What's more, the final product will be accessible. It's educational potential will be available in the South Bronx and in Appalachia as well as in the wealthier areas of the country.

While the responsibility for realizing this goal rests primarily with the private sector, the leverage of government programs will be used to make its benefits truly public.

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Dr. Sununu, I recognize the cheekiness of my trying to frame a national goal for the President, but it's one I think we can do and, just as important, it has something in it for virtually everyone. We need such a goal.

I realize how sketchy this letter is but I'd be happy to talk it over further with you if you like. There has really been far more thought involved in the program than appears at first reading. I'll be in South America from March 16th to the 26th but my secretary can get in touch with me.

Thanks for reading -- I hope this can help.

Sincerely yours,



Jordan J. Baruch

Big Dooley -

Presidents and others talk about "line item veto" as if all voters know what ~~the~~^{special} talking about, and why. I aint so. Reagan defended his role for wanting a balanced budget in terms that people didn't understand. That's why Congress ~~was~~ was able to sell the idea of the "Reagan deficit."

President Bush wants to lower the capital gains tax. He assumes voters understand. Most do not. The Scott Burns article would allow you to write a brief explanation for insertion in a speech.

If you ever are called upon to write about line-item veto, explain that some legislation carries pork-barrel amendments for study of the sex-life of the Australian, turt diddle, or some such. To get legislation into law, the President must accept the pork barrel issues, etc., etc. . . Dad

Lowering the investor tax would be a capital idea

SCOTT BURNS

Continued from Page 1D. Cause more capital gains will be realized and, therefore, taxed in effect, what the Treasury loses in lower rates will be made up in volume.

Which brings us to an important distinction. The capital-gains tax is voluntary.

You and I don't have much choice about our income taxes. We pay taxes for the wages and salary we are paid. Indeed, we pay them on the spot and don't have much choice about it.

But capital gains are different. If you own a stock that has appreciated handsomely, you might think it wise to sell it, or some of it — but it is a decision. You can delay the sale for a year. Maybe two years.

In fact, if you're really spiteful and hate paying taxes, you can simply refuse to sell your stock and keep the capital gain until you die. Then it will magically disappear in the valuation of your estate. (Some wags have suggested this is our only remaining incentive for dying.)

In effect, we have a choice about capital-gains taxes. We can pay at a tax rate of 0 percent by not selling the asset. Or we can pay at a tax rate of 15, 28 or 33 percent, depending on our income. The larger the difference between zero taxes and the tax rate we'd have to pay, the greater the chance transactions will be suppressed.

My bet is that lots of people, confronted with a tax of 28 to 33 percent, will elect to die with their stocks on. Ironically, while creating a "level playing field," Congress will have imposed a high tax on people who have circumstances that force them to sell assets while allowing people with abundant means to, in effect, "take it with them" when they die.

■ Fairness. Probably the most popular argument against lowering the tax is that it will be just another tax break for the very rich. In fact, while capital gains are an important part of the income of the rich, people who aren't rich have capital gains too. They just don't have as many. According to Internal Revenue Service figures, about 28 percent of all capital gains are realized by people with adjusted gross incomes of \$100,000 or less.

mists call a high propensity to save, lowering the capital-gains tax should have a dramatic impact on our national savings rate. It would increase.

Increase the domestic savings rate enough, and we might not depend on foreign lenders to finance the federal deficit. Interest rates would fall, the deficit would fall, and even people with nothing but debts would benefit because the cost of financing a house, a car or anything else would decline.

To be sure, the benefit is indirect, but it is real. Let's put it this way: Would you mind if the rich got to pay taxes on capital gains at only

15 or 20 percent if you knew you could get a new home mortgage at 7 percent as a result?

When push comes to shove, "fairness" doesn't apply very well. People with large incomes and capital tend to save. If we want to increase our rate of saving, the fastest way is to decrease the capital-gains tax.

■ Economics. It may be nice to have a "level playing field" in America — but do we want to do it by forcing ourselves to run on one leg, while the rest of the world runs with two?

While we debate whether the capital-gains tax should be 20 or 28 percent, the two nations that are eat-

ing our lunch, Japan and Germany, have virtually no capital-gains taxes. Long-term gains are exempt from taxes in Germany and are taxed at 5 percent in Japan.

One result is that both nations have a lower cost of capital than we do. They compete using 5 percent financings; we compete using 12 percent financings and have difficulty

raising equity capital.

While U.S. manufacturers cut back inventory because it costs so much to keep stock on shelves, the Germans and the Japanese can do it with ease. It costs them half as much. Day after day, they have more to sell, and they have it now, so domestic manufacturers lose market share.

The first playing field to level is the big one, the global one. After we've done that, then we can look at what we do domestically to make different parts of society feel better. That is, in exchange for a lower capital-gains tax rate, we restore the IRA deduction and, perhaps, expand the personal exemption. That would benefit the many, without risk.

Lowering investor tax a capital idea

Funny things happen in Washington.

Right now, for instance, there is an on-going debate about the capital-gains tax. President Bush has proposed lowering it, restoring most of the "preference" that capital gains enjoyed before the 1986 tax reform.

In case you don't remember, before Congress made a big fuss about having us all play on a "level playing field" by bulldozing the nation's real estate values, they also taxed capital gains at lower rates than ordinary earned in-



SCOTT BURNS

come.

Before 1986, one-half of all capital gains escaped taxation altogether, and the highest tax you could pay was 20 percent. After 1986, every dime of capital-gains income became taxable and was thrown into the same pot as wage income — so it was taxed at 15, 28 or 33 percent.

Which means that capital-gains taxes were increased. For some people — not the very rich — the tax was increased substantially.

Although a growing constituency believes that the best tax law would be a stable tax law, whatever it was, a good case can be made that arguments for a "level playing field" notwithstanding, we have a pressing need for a lower capital-gains tax. Here are the arguments:

■ Tax revenues. One of the popular arguments against lowering the tax is that it will reduce federal tax revenues when we have a pressing need for more revenues, not less. After all, there is still a massive federal deficit.

This kind of discussion brings out all the technicians, the econometricians and their models, to estimate the impact.

The Congressional Budget Office, which regularly makes the implausible assumption that individuals never respond to changes in the tax laws by altering their behavior, believes that a reduction in capital-gains tax rates will work to reduce capital-gains tax revenues.

The Treasury, which once thought the same way, now thinks revenues will increase. Please see LOWERING on Page 7D.

47-01
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In fact, if we are going to address a major problem, it might be good to turn the entire argument around. People with incomes more than \$200,000 a year account for 59 percent of all capital gains. Since people with such incomes have what econo-

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LEISURE & ARTS

Rock of Ages: The Who Turn 25

By PAM LAMBERT

East Rutherford, N.J.

"Somebody in the end said to me, 'Well, what would you do it for? What would be a price that you'd go out and endanger your hearing and push yourself closer to that inevitable knee operation, what would it be worth?'" rock star Pete Townshend recounts with a grin. "And I sort of pulled a figure out of a hat and the price I named was one million five hundred thousand pounds after tax."

And so it was this past weekend that the grizzled guitarist found himself facing four sell-out crowds at Giants Stadium with a band he describes as "dead dogs" in creative terms, a band that had disbanded seven years ago, a band called The Who.

Songwriter Townshend and the other surviving members of the British group, singer Roger Daltrey and bass player John Entwistle, were kicking off a summerlong 25th anniversary tour which takes them to Washington's RFK Stadium tomorrow and Friday. By its end Sept. 3 they will have performed 40 stadium shows plus two charity benefits of Townshend's pioneering rock opera "Tommy." They will take home at least \$30 million.

Fans responded to The Who reunion by snapping up tickets in record time. The rock press reacted less warmly. Critics who've never told Bob Dylan to pack it in—despite his dismal recent songwriting—seemed somehow offended that the author of the ultimate teen anthem "My Generation" and his mates would have the temerity to return for one last hurrah.

Maybe they feared a fortysomething group couldn't possibly compete with memories of the days when, driven by Townshend's full-contact guitar attack, the band set rock standards for power, volume, and demolition. Maybe they were fed up with all the "dinosaur" acts dominating this summer's concert calendar. Or perhaps they were just put off by Townshend's candor in discussing his motives, which include the desire to publicize his ambitious solo project "The Iron Man" (Atlantic)—the only record release coinciding with the tour.

"We actually sold very, very few albums relative to our popularity," Townshend says during a pre-concert interview. Fatigue evident on his basset hound features, he looks more like a man ready for

"cast the band in stone" as fans came to expect more of the same. After that, "none of us really knew what kind of record we should make."

Townshend confesses to similar trouble as a solo-artist. "When I start to make a record I don't know what *style* to make it in," he explains. "I like too much music." Indeed, his new "Iron Man" album, containing songs from the musical he hopes to stage next year, may stun many Who fans with its diversity and rich orchestration. What won't surprise anybody familiar with "Tommy" are the themes of the work, based on a children's fable by English poet laureate Ted Hughes.

"They're both about frightened little boys, I suppose, a subject which I can still write about," Townshend says with a chuckle. "I think that I did carry an enormous amount of my childhood self into adulthood, and that's something I'm very grateful to rock about. One thing you're allowed to do as a rock performer is to be a child—sometimes you're positively encouraged to be one. Unfortunately you're not protected as a child is protected, so sometimes you kind of die in the process."

The Who's gozno drummer Keith Moon was one such casualty, ODing in 1978 on medication he was taking to help stop drinking. Townshend was nearly another. One of his excesses, years of drunkenly practicing guitar through headphones at deafening volume, caused tinnitus—constant ringing in the ears. So "Tommy," the saga of an abused deaf, dumb and blind boy, is now being performed by a man unable to fully hear his own music.

At the "Tommy" benefit last Tuesday at New York's Radio City, some changes were immediately evident. To fill out the songs at the lower volume demanded by Townshend's damaged ears, The Who had ballooned to big band size: 15 musicians including five horns and three backup vocalists. (The stage will be even more crowded for the fundraiser August 24 at Los Angeles's Universal Amphitheater, a performance with guest stars to be simulcast on pay-per-view cable.) And Townshend, whose powerful rhythmic chording and slashing style influenced a generation of electric players, was sporting an acoustic guitar.

As the band moved briskly through the hour-plus of this slightly condensed "Tommy," the rejiggered arrangements worked surprisingly well. There were

ing, it's the electric Townshend that ignited The Who's legendary live act.

One had only to compare this set's "Baba O'Riley," featuring Townshend on acoustic, with previous tours' electric versions as captured in the 1979 Who documentary "The Kids Are Alright." There you can't take your eyes off the bobbing, bouncing guitarist, and the sounds he wrests from his Gibson Les Paul seem to be an organic outgrowth of his perpetual motion.

"From the moment I put the electric guitar on I start to loosen up physically," he confirms before the stadium show, "and then adrenalin starts to flow and then I don't really know what I'm doing any more."

The story was pretty much the same at the concert itself, which avoided the predictable greatest-hits pathway. After opening with a half-hour of "Tommy" tunes, the program ranged thoughtfully throughout The Who's career, focusing on some of the outstanding early work which Townshend feels has been slighted. There were side trips into members' solo efforts, and interesting cover versions of music that influenced the group. The band particularly smoked on Bo Diddley's "I'm a Man." Daltrey's vocals were down and dirty; Townshend slow-danced with his red Stratocaster.

For much of the show, though, Townshend was a more subtle presence on acoustic. This shifted some attention to bassist Entwistle, whose dynamic playing has long been overlooked. But, mainly Townshend's subdued performance had the effect of putting the songs in the spotlight. Judging from the response of the youngist crowd, this music is already moving the next generation.

Photo Copy Preservation

Michael Kinsley

George on My Mind

The 150th birthday of the man who explained it all.

Some agency in Tokyo announced recently that Japan is now richer than the United States, thanks largely to the explosion in Japanese land prices. Adherents of the American economic philosopher Henry George will recognize the fallacy immediately. How is a society enriched by the fact that the same land now sells for twice as much? This simply represents a transfer of wealth to land owners from those who wish to own land: overwhelmingly, other Japanese.

Henry George was born 150 years ago in Philadelphia. He dropped out of school at age 13, wound up working as a printer in San Francisco and, in 1879, self-published his masterpiece, "Progress and Poverty." It became a best-seller, and George himself became "the third-most famous man in the United States" after Mark Twain and Thomas Edison, according to his granddaughter Agnes George DeMille (yes, the choreographer). Soon after George died in 1897, however, his theories were almost completely forgotten.

George began from the premise that there are three factors of production—labor, capital and natural resources—(primarily land). All the

world's wealth is created from these elements and divided among the worker, the capitalist and the landlord. But whereas the return to labor is the reward for effort and the return to capital is the reward for saving, the return to land is the reward for nothing more than possession of a limited resource.

The rising value of land, George reasoned, is not the result of the owner's efforts but a result of the growth of society. If, you own land, "you need do nothing more. You may sit down and smoke your pipe; you may lie around like the lazzaroni of Naples or the leperos of Mexico; you may go up in a balloon, or down a hole in the ground; and without doing one stroke of work, without adding one iota to the wealth of the community... you will be rich."

The landowner's profit, George maintained, is merely a tax on the truly productive factors, labor and capital. And George's solution was to tax away the entire rental value of land, using the proceeds to abolish all other taxes. "Taxation which diminishes the earnings of the laborer or the returns of the capitalist," he argued in good supply-side fashion, "tends to render

the one less industrious and intelligent, the other less disposed to save and invest." By contrast his solution would, in one swoop, "raise wages, increase the earnings of capital, extirpate pauperism, abolish poverty, give remunerative employment to whoever wishes it, afford free scope to human powers, lessen crime, elevate morals and taste and intelligence, purify government and carry civilization to yet nobler heights."

Obviously there are problems with this magic cure-all. Land is not the root of all economic evil. And George had no satisfactory answer to the complaint that most current owners of natural resources paid at least part of their current value, so expropriating all that value through taxation would be unfair.

But George's instinct that the hidden "landowners tax" on the productive elements of society would grow with time and prosperity is probably correct. According to Federal Reserve figures, the share of America's national wealth represented by land grew from a fifth in 1946 to a quarter in 1988. There is the same amount of land in America as there was at the beginning of the postwar boom, but

landowners' claim on all the wealth that has been produced since then has grown disproportionately.

Real estate has always been the largest category in the "Forbes 400" list of the richest Americans. In the 1989 list, just published, it slips narrowly to second place with 77 out of 400. But most on the list owe at least a part of their wealth to ownership of real estate or mineral resources such as oil. America's richest man, John Kluge, increased his fortune by \$2 billion last year simply by owning cellular telephone franchises given away free by the government. Henry George was viciously witty about fortunes built on government-granted monopolies.

What I like best about Henry George is the way he combines radical egalitarianism with an equally radical belief in free-market capitalism. But he noted the difference between capitalism in theory and the actual economy he saw around him. He distinguished between the accumulation of wealth and the creation of wealth. And he recognized that wealth accumulated in nonproductive ways was not merely unfair but actually bad for economic growth.



George would sneer at the policy of giving away broadcast licenses for free. He would understand the logic of an excess-profits tax on domestic oil and gas. He would see the futility of various current liberal schemes to "help" first-time home buyers through government subsidies, all of which will simply get capitalized into higher home prices. He would go ballistic over the idea of reopening the capital gains tax break for real estate.

Above all, perhaps, George would observe how the developed world has been suffering in recent years from real estate sickness. At times when the reward for happening to own a middle-class house has been greater than the reward for middle-class labor, this disease has twisted values, sucked away productivity and redistributed wealth at random. And if, as many believe, the process is now going into reverse, the dislocations will be just as severe.

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THE WASHINGTON POST

Study Sees Shortfall of Graduates in Technical Skills

Task Force Recommends Efforts to Recruit Women and Minorities in Science, Engineering

By Kenneth J. Cooper
Washington Post Staff Writer

To meet labor market demands for technical skills in the next century, a congressionally chartered panel estimates that the nation's colleges must graduate twice as many white women in science and engineering, five times as many black students and seven times as many Hispanics—beginning next year.

The panel, established by Congress in 1986, arrived at the estimates by combining projections from the National Science Foundation, which foresees a shortfall of 560,000 scientists and engineers in the year 2010, and the Bureau of Labor Statistics, which projects that 85 percent of new workers in the year 2000 will be women or minorities.

"These numbers are real in the sense that all of these people who will be entering the work force are already born," said Sue Kemnitzer, executive director of the Task Force on Women, Minorities and the Handicapped in Science and Technology. The panel of 48 government, business and education leaders issued its final report yesterday.

The panel said the projected increases in undergraduate degrees in engineering and science must be achieved in every year of the 1990s, a goal that Kemnitzer acknowledged would be impossible to reach next year. "That is one point we're trying to get across—how dramatic the changes have to be," she said.

The panel's projected demand for women and minorities with doctoral

degrees in science and engineering are even higher: three times as many white women, 12 times as many Hispanics and 20 times as many blacks. Last year, for instance, only 47 black Americans received doctorates in science and 15 in engineering.

No estimates were made concerning handicapped students because no statistics are collected on the types of degrees they receive.

In its long list of recommendations, which were endorsed by the White House Office of Science and Technology Policy, the panel proposed that:

■ Colleges "set quantitative goals for recruiting and graduating more students in science and engineering, especially from underrepresented groups." But the panel, Kemnitzer said, rejected specific quotas for each group.

■ The federal government provide college scholarships and research experiences to high school students who want to pursue science and engineering, particularly to women, minorities and handicapped students. President Bush has proposed funding two such scholarships in each congressional district.

■ Local school districts station a math and science expert in each elementary school and emphasize scientific careers as "the best way 'up' for students from disadvantaged backgrounds." Currently, most elementary teachers do not specialize and provide instruction in every academic subject.

■ Private, industry fund training programs to improve the math and science knowledge of teachers, including sponsoring trips to national meetings of math and science teachers.

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MAY 16, 1990

Don't Raise Taxes

By Martin Anderson

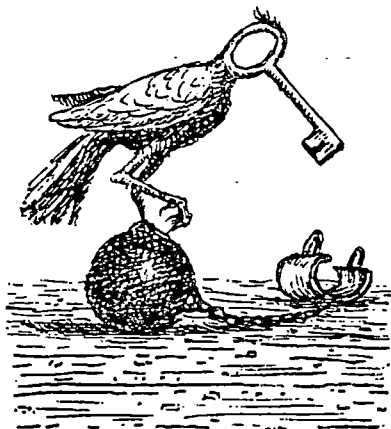
The brazen cry to raise taxes in 1990 has to be the most shameless assault on Americans' pocketbooks in this century.

We have just had the largest back-to-back annual tax increases in our history. In 1988, the Government got \$751 billion of our money. This year, it will get that and another \$165 billion. That whopping increase in tax receipts — a product of economic growth and inflation — is one of the best kept secrets in America.

Washington is awash in tax money.

During the next three fiscal years, tax revenues are expected — without any change in tax rates — to increase by another \$254 billion. That's a grand total of \$419 billion of new spending money for the Federal bu-

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reaucrats in just five years. It is almost \$1 billion of new tax money for every single Congressman.

Surely, \$419 billion is more than enough for those rascals.

Then how can there be a problem? Because politicians want to spend even more than the cash that is flooding in on them. Displaying remarkable ingenuity, they have figured out how to spend much, much more than the paltry \$1 trillion and change that they have today.

And that is unconscionable. Here we are rolling along in the 89th month of the greatest economic expansion in our history, with 19 million new jobs, a gross national product of nearly \$6

The deficit isn't the real problem.

trillion, low inflation, interest rates and unemployment, a stock market that has tripled in the last seven years — and these bozos want to jeopardize it all by raising tax rates.

Moreover, the collapse of socialism and the prospects of bilateral nuclear disarmament will soon produce a financial windfall. The savings over the next decade could easily accumulate to more than \$500 billion.

How bad is the Federal deficit? The deficit, as a percentage of gross national product, has fallen steadily since 1985 (when it was 5.4 percent) to an estimated 2.2 percent for 1990. Even with the latest revised "the sky is falling" estimates, the deficit would still be only 2.6 percent of G.N.P. in 1990 and 1.5 percent in 1991. We have had deficits in this range many times before. They are serious but not catastrophic, and certainly not justification for raising tax rates and jeopardizing the economy.

The same is true of Federal debt. As a percentage of G.N.P. it has been falling in recent years and now stands at about 40 percent. That is lower than at any time from 1945 to 1965. It was not a serious problem then, and it is not a serious problem now.

The real problem with our economy is that politicians want to spend more of our money than they have any right to. But where is it written that government has a right to an ever-increasing share of our income?

In fact, as our economy grows ever more huge — into the \$6 trillion and \$7 trillion dollar range — we should be getting savings in Government operations from economies of scale. As peace breaks out around the world and our economy gets bigger, the Government should take a smaller percentage out of our pockets.

Rather than raising taxes, we should be taking decisive steps to keep the economic expansion rolling, to create more jobs. In addition to refraining from tax hikes, here are three things we should do in 1990:

- Eliminate the capital gains tax (which will create hundreds of thousands of jobs and put us on a more equal footing with foreign competitors), and delay any increase in the Social Security tax for at least one year. Getting rid of the capital gains tax will raise Federal revenues. Delaying the Social Security tax for a year would cost about \$12 billion.

- Earmark all of the "peace dividend" for further deficit reduction and to pay for the delayed Social Security tax increase.

- Slow, by a measly two or three percentage points a year, the incredible growth of Federal spending. If we could do that, we could balance the budget easily in a few years.

When it comes to spending taxpayers' money, politicians and bureaucrats — of either party — have no sense of restraint. They need to be disciplined.

The only way to deal with them is to just say no — no more new taxes.

Read our lips. □

Moynihan Lays Budget Debate Bare

By HERBERT STEIN

In the fairy tale, when the small boy said that the emperor had no clothes on, the townspeople immediately agreed and got an emperor with more sense and decorum.

In the real world, of course, the elder statesmen whisked the boy away and shut him up, because they knew that the truth threatened their positions and privileges.

Sen. Daniel Patrick Moynihan's proposal to cut the Social Security payroll tax reveals that our fiscal policy and especially our talk about it is bare of logical clothing. Whether the New York Democrat's proposal will have the fairy-tale ending or the real-world ending is uncertain. I would bet on the real world.

The idea of cutting payroll taxes raises many sensitive questions:

If raising taxes is a sin, isn't cutting taxes a blessing?

If raising taxes would invite all kinds of wasteful expenditure, wouldn't cutting taxes eradicate wasteful expenditure?

If cutting the capital-gains tax would increase the national income and raise the federal revenue, wouldn't cutting the payroll tax have the same effect? (I believe that for \$100,000 I could get an econometrician to prove that it would.)

If cutting the capital-gains tax would be good for labor because it increases the supply of capital with which labor works, wouldn't cutting the payroll tax be good for savers and investors because it would increase the supply of labor? (For an additional \$50,000 I could get that proved also.)

The 1981 Tax Cut

If cutting the payroll tax is a bad idea because it would require the next generation to pay higher taxes to cover Social Security benefits, wasn't the 1981 tax cut a bad idea because it requires future taxpayers to pay higher taxes to cover the interest on the debt resulting from the tax reduction? And wouldn't it be a good idea now to raise taxes so that the next generation will not have to pay such high taxes to cover the interest on the debt we are now accumulating?

And if cutting the payroll tax would reduce the revenue, are the Office of Management and Budget and Congress now so devoid of imagination that they cannot find a way to get the revenue loss outside the Gramm-Rudman deficit calculation?

And even if cutting the payroll tax would violate the Gramm-Rudman deficit limits, what is so great about those limits anyway?

Discussion of the Moynihan proposal could puncture a lot of too-hot-air balloons, if the discussion is not snuffed out by the poobahs of both parties who fear that such talk might lead to the idea that there should be a T-X increase. And beyond this valuable, even though negative, result, the Moynihan proposal may lead to serious consideration of the two real issues involved. They are a) what the size of the deficit or surplus in the consolidated federal budget (including Social Security) should be and b) how Social Security

should be financed.

The surplus-deficit question is a question about the desirable rate of national saving and investment, which is important because of its effect on the rate of growth of the national income. The larger the budget deficit the smaller is the share of private saving that is available to finance private investment, and the smaller the private investment the slower will be the growth of the national income.

One could argue that continuation of substantial budget deficits is appropriate, for several reasons. Per-capita income in the U.S. is very high and it is still growing, although not so fast as in some earlier periods. Getting richer faster is not one of our most urgent needs. People in some

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other countries have a high propensity to save and to invest here, which reduces the importance of our own saving. Also, the Americans of this generation have made, and continue to make, a higher-than-usual investment in the security of future generations—which should count in any reckoning of what we owe our children and grandchildren. Moreover, there are some studies to suggest that the contribution to economic growth made by more saving, per se, is small compared, for example, with the contribution of education and research.

On the other hand, there are reasons to believe that the federal government should be running a surplus to contribute to the national saving. The private saving rate is lower than it used to be—before 1980—and we have been absorbing an extraordinarily large part of the private saving to finance the budget deficit. Thus, the stock of capital owned by Americans has been rising slowly. Also we have ahead of us an increase in the proportion of the population that is retired, which means an increase in the proportion of consumers to producers. This makes a case for building up the stock of income-producing capital to ease the future burden of taking care of the retirees.

Objective evidence does not tell whether the surplus path or the deficit path is superior, let alone choose among deficits or surpluses of different sizes. By their actions and the actions of their elected representatives in the 1980s the American people have revealed a preference for the deficit path. My own senti-

ments are for the surplus. I would not oppose my sentiments to those of the American people, but I do not believe that the issues have been presented to them clearly. Perhaps Sen. Moynihan's proposal to cut the revenue will prod people into thinking whether, why and how much they care about the deficit.

With respect to the financing of Social Security there are three main options, although various combinations are conceivable:

- Social Security benefits could be financed out of the general revenue, just as national defense and interest on the debt are financed. This seems manifestly unfair. Most Social Security benefits go to people who are not poor and who have no legitimate claim to support from the general taxpayer. Their only legitimate claim to the benefits is that they paid for them themselves, through the payroll tax. And the only justification for the payroll tax is that it is the way of paying for the benefits. (And that is why the claim that the payroll tax is "regressive" is beside the point.)

- Social Security benefits could be paid for by payroll taxes on a "pay-as-you-go" system. That is, each year's payroll taxes would be sufficient to pay that year's benefits. That would be an unfair system because the payroll tax paid by each worker would depend not on the cost of his own benefits but on the costs of the benefits of people who are retired while he is working. Thus, a worker when the number of pensioners is relatively low would pay less tax than a worker when the number of pensioners is large. Following this system now would mean a much lower payroll tax rate today than 30 years from now, when the ratio of pensioners to workers will be much higher.

The Fairest System

- Social Security benefits could be paid for by the contributions made on behalf of each worker during his lifetime, plus accumulated interest. Each worker would pay for his own benefits. This is the general system under which we are now operating, although it does not apply exactly to each worker. This is the fairest system. It means that reserves would be accumulated during periods when the ratio of retirees to workers is low as now, and depleted when the reverse is true, as it is expected to be in 30 years or so.

If the Moynihan proposal were adopted, the present generation of workers would not be paying enough to cover the costs of its future benefits. When these workers retired, their benefits would have to be made up from higher payroll taxes on the people then employed or from the general revenue. That is the basic flaw in the Moynihan proposal and the reason it should not be adopted. The basic virtue of the proposal is that it may force some thinking, rather than lip-reading, about taxes and the budget.

A former chairman of the president's Council of Economic Advisers, Mr. Stein is an American Enterprise Institute fellow.

Analogies between the United States and post-imperial Britain are inaccurate and mischievous. "Americans can afford both social and international security," the author argues

THE MISLEADING METAPHOR OF DECLINE

BY JOSEPH S. NYE, JR.

WHEN THE UNITED STATES EMERGED from the Second World War with its armies victorious and its dollar impregnable, Arnold Toynbee argued that it had to succeed Britain as the leader of the world. Comparisons to Britain are still being made, but now they emphasize the negative rather than the positive. According to one recent poll, nearly half the American public believes that the United States, like post-imperial Britain, is in "decline."

Some scholars have suggested that America's decline follows a pattern that has recurred throughout history. A growing nation builds its military power to protect its expanding economic interests, but eventually the cost of sustaining such power saps its strength and another rising economic power takes its place. The sociologist Immanuel Wallerstein sees such imperial overstretch as a regular happening, with Venice starting to decline around 1500, Holland around 1660, Britain around 1873, and America around 1967. Paul Kennedy, in the best-selling book *The Rise and Fall of the Great Powers* (which was previewed in the August, 1987, *Atlantic*), writes that "the difficulties experienced by contemporary societies which are militarily top-heavy merely repeat those which, in their time, affected Philip II's Spain, Nicholas II's Russia, and Hitler's Germany."

Such historical analogies suggest that major foreign-policy changes are in order, but if the analogies are misleading, the diagnosis may be wrong. Retrenchment could produce the very weakening of American power which it is supposed to avert. Withdrawal from international commitments might reduce American influence overseas without strengthening the domestic economy. In fact, the nations of the world have become so inextricably intertwined that efforts to draw back would surely be frustrated.

Concern about decline would be good for the United States if it cut through complacency and prodded Americans to deal with serious domestic issues like savings and education. But polls suggest that excessive anxiety about decline is turning American opinion toward nationalistic and protectionist policies that would constrain our ability to cope with the realities of growing international inter-

dependence. Thus there is no virtue in either overstating or understating American strength. The former leads to failure to adapt; the latter could lead to cures that do more harm than the disease.

The Vicissitudes of Decline

THE IDEA OF DECLINE HAS HAUNTED THE WESTERN imagination since the fall of Rome, and a long history exists of premature and misleading predictions of decline. Many eighteenth-century British statesmen, for example, lamented Britain's decline as a result of losing the American colonies. Horace Walpole foresaw Britain's reduction "from a mighty empire . . . [to] as insignificant a country as Denmark or Sardinia!" Colored as they were by the eighteenth-century view of colonial commerce, such prophecies could not foresee the new industrial base of power in the Victorian period which would give Britain a second century at the top. Yet even then, at the height of Britain's ascendancy, Matthew Arnold worried of "an imminent danger of England losing immeasurably in all ways, declining into a sort of greater Holland."

Decline bundles together two quite different concepts: a decrease in external power, and internal deterioration or decay. A country, though, may experience decline in one sense but not in the other. For example, the Netherlands flourished internally in the seventeenth century but declined in power *relatively*, because other nations became stronger. Spain, in contrast, lost external power in part because it suffered an absolute economic decline from the 1620s to the 1680s.

Obviously, internal deterioration can contribute to a loss of external power. Even so, it is often difficult to identify which internal changes accounted for the loss of power and when they occurred. Scholars have advanced more than two hundred causes for the decline of Rome and still disagree on dates. The Romans themselves often saw their world in despairing terms; in fact, prophecies of decline were heard as early as 154 B.C., six centuries before the conventional date for the fall of Rome. In the prime years of decline—A.D. 300 to 450—the Roman economy remained healthy.

As one historian concludes, "The 'Rome' that 'declines' is thus not one single thing but many things and the search for any one cause across the board is futile. So, too, is the search for any one period in which all aspects of Roman civilization were much changed." The eastern half of the Roman Empire survived, under increasingly precarious conditions, for nearly a thousand years after Roman armies could no longer protect the western provinces. The Western Empire was not the victim of a rising challenger state. It succumbed to the long-term pressure of invading migratory tribes. "In any straight fight they could, and they usually did, defeat superior numbers of Germans," one historian writes. "What they could not do was cope indefinitely with this kind of enemy."

Power is a relational concept. It depends partly on what is happening at home, but even more on what is happening outside. An empire may last for a long time after aspects of its civilization begin to decay at home, as long as outside challengers are weak. Although civic corruption and a loss of administrative and military efficiency may have allowed nomadic tribes to sack Rome, Rome's external challengers were weak. The "fall" in 476 came some two centuries after the onset of major corruption in the government and deterioration in the military.

A nation may also decline relative to others because it chooses not to use the resources of power at its disposal. For example, France in the early eighteenth century allowed its naval and fiscal resources to stagnate relative to Britain's; but, unlike Spain's decline in the previous century, the French one was not permanent. The stagnation in French war potential did not represent an absolute decline, as the subsequent military exuberance under Napoleon proved. Yet in terms of basic resources, the political scientist Charles Doran writes, "France's ability to expand militarily was greater in 1750 than it would be in 1805." To take a more modern example, the United States emerged from the First World War a potentially dominant

global power. But it chose a policy of isolationism that made it a secondary player in world political events. American influence was less in 1928 than in 1918, but not because America had lost power.

What the Numbers Say

THERE IS NO QUESTION THAT THE UNITED States is less powerful at the end than it was in the middle of the twentieth century. Even by conservative estimates, the U.S. share of global production has declined from more than a third of the total after the Second World War to a little more than a fifth in the 1980s. The United States was strengthened by the war; the other great powers were devastated. In that sense American economic preponderance in the 1950s was anomalous, like being the boy on the block who dominates while others have the flu. American preponderance was bound to erode as other nations regained their economic health.

Paul Kennedy argues that the U.S. decline has been continuous: "The U.S. share of world GNP, which declined naturally since 1945, has declined much more quickly than it should have over the last few years." The political scientist David Calleo is even more alarmist: "Thanks to economic strain and mismanagement, relative decline has begun to turn absolute."

But the figures do not support the case for a continuous decline in America's share of world product. Charles Wolf, of the Rand Corporation, points out that "if a more appropriate and representative base year is used—say, the mid-1960s (or even a pre-World War II year such as 1938)—the remarkable fact is that the U.S. economy's share of the global product was about the same 'then' as it is 'now': about 22% to 24%."

Some estimates of the U.S. share of world product date the fading of what we might call the Second World War effect somewhat later than Wolf does, but the result is the same. For example, the economist Herbert Block es-



THE AMERICAN SITUATION IS DIFFERENT FROM THE MOST FREQUENTLY CITED CASE, THAT OF BRITAIN. EXPLAINING BRITAIN'S DECLINE HAS BECOME ALMOST AN INDUSTRY IN ITSELF.

imates that the United States accounted for about a quarter of world product at the beginning of the twentieth century, and about a third in 1950. The postwar U.S. share declined until 1974 and then stabilized. The American Council on Competitiveness similarly finds that the U.S. share of world product has held constant at 23 percent since the mid-1970s. The U.S. share of the product of the major industrial democracies actually increased slightly in the 1980s. The Central Intelligence Agency, using numbers that reflect the purchasing power of different currencies, shows the American share of world product increasing, from 25 percent in 1975 to 26 percent in 1988.

Such numbers call into question the view that American decline has been either precipitous or continuous. They suggest instead that the Second World War effect lasted about a quarter century or so and that the American position thereafter stabilized. Most of the decline had worked its way through the system by the mid-1970s.

According to the overstretch theory, a great power is likely to find that it is spending much more on defense than it did two generations earlier, yet its world is less secure. But American numbers do not fit the theory. Even after the Reagan Administration buildup, the current U.S. defense outlay is about six percent of GNP; in the late 1950s it was about 10 percent.

Furthermore, the United States defense burden is not at all like those of Spain and France in their last days of grandeur. Philip II's Spain devoted three fourths of all government expenditure to war and war debt. The France of Louis XIV and the Russia of Peter the Great appear to have devoted 75 and 85 percent respectively of their revenues to war and the military establishment. In the United States today about 27 percent of the federal budget is spent on defense (including veterans' benefits). And unlike the historical examples, America's overseas commitments do not involve the permanent occupation and control of conquered territories.

The ratio of America's defense burden to its share of world product was actually lower in the 1980s than in the 1950s. Indeed, contrary to the theory of imperial overstretch, the U.S. defense burden today is lighter than it was in the 1950s, and the political burdens of U.S. commitment are lighter today than they were in the 1960s, during the Vietnam War.

This does not mean that the current defense budget is wisely constructed. On the contrary, the buildup of the 1980s was hasty and enormously wasteful, and the government has not made enough hard choices in cutting back the procurement of unnecessary weapons systems. Given the changes in world politics, a strong case can be made for allocating more resources to international institutions, communications, and assistance to critical countries. If such expenditures are necessary, the country can afford them. Unlike the historical examples—or the Soviet Union today, where defense expenditures constitute some 17 percent of GNP—the United States does not fit the theory of imperial overstretch.



THE POPULAR BELIEF THAT
BRITAIN WAS SUFFERING FROM IMPERIAL
OVERSTRETCH PREVENTED BRITAIN
FROM INVESTING AS WELL AS IT MIGHT
HAVE IN THE RESOURCES OF POWER THAT
COULD HAVE SLOWED DECLINE.

**The Decline
of British Power**

SOME CRITICS ARE skeptical of such aggregate measures and prefer historical analogy. The American situation, however, is different from the most frequently cited case, that of Britain. Explaining Britain's decline has become almost an industry in itself. A long list

of domestic causes has been adduced, and has been in the making for a long time. As early as 1898 Henry Adams believed that "British industry is quite ruined." But he also believed that "Germany has become a mere province of Russia." In 1900 his brother Brooks Adams wrote that since 1890 "an impression has gained ground that England is relatively losing vitality, that the focus of energy and wealth is shifting, and that, therefore, a period of instability is pending." He blamed British lethargy and high living, in part, and pointed to the Boer War as an indication that Britain was no longer willing to accept casu-

alties in war. Of course, that notion was soon disproved by the enormous British losses in the First World War.

In fact, the First World War showed Britain to be an impressive power. It had not only manpower but also industry capable of being mobilized for war, overseas investments that could finance the purchase of U.S. technology and war supplies, and a navy large enough to ensure control of the Atlantic. Britain could also call upon the resources of its empire. Of the 8.6 million members of the British forces in the First World War, nearly a third came from overseas (though four fifths of the expenditure was British). By 1918 Britain had the world's largest air force and navy, and the empire had reached its maximum size. In 1921 both popular and informed opinion in Britain agreed with General Jan Smuts, of South Africa, that the British empire had "emerged from the War quite the greatest power in the world."

Yet the war—or, more precisely, the thirty-year struggle with Germany—did more to hasten British decline than any other factor. Competing with Germany, rather than possessing an empire, is what drove up defense spending. It is perhaps too simple to say, along with Woody Allen in *Zelig*, that "Britain owned the world and Germany wanted it." But if Bismarck and his successors had not unified the German states into a single Continental force after 1870 (with a population larger than Britain's), the British era might have lasted longer. It was Germany, not the pre-1914 empire, that overstretched Britain.

OF COURSE, THE BRITISH ERA WOULD NOT HAVE lasted forever. Nothing does. Early in the nineteenth century Alexis de Tocqueville pointed out the enormous potential of the United States and Russia. In 1835 the English statesman Richard Cobden declared that "our only chance of national prosperity lies in the timely remodeling of our system, so as to put it as nearly as possible upon an equality with the improved management of the Americans." In 1883 the Cambridge historian Sir John Seeley argued that federation of the empire was the only way that Britain would be able to compete with Russia and the United States, which were "on an altogether different scale of magnitude." In 1878 the former (and future) Prime Minister William Gladstone worried that America "can, and probably will, wrest from us [our] commercial superiority."

In short, Britain's relative power was bound to decline, because of a number of external factors. The spread of industrialization raised new economic and military competitors. The growing strength of Germany meant that Britain would no longer have a free ride on the Continental balance of power. The spread of railways meant that Britain would no longer have as much time to raise interventionary forces and transport them to the Continent.

The distribution of power in the regional balances of

the Atlantic and the Pacific was also shifting, because of the growing strength of both the United States and Japan. By the turn of the century British planners felt they could no longer afford a navy that dominated the Pacific and the Western Hemisphere as well as home waters. Thus Britain signed an alliance with Japan and appeased the United States with a number of conciliatory measures, including accession to the Panama Canal, which further enhanced American naval strength by allowing the United States to shift its fleet quickly between two oceans. Henceforth, as Aaron Friedberg, a political scientist at Princeton, has shown, Britain applied its traditional two-power naval standard—having a navy equal to those of the next two contenders—only to home waters.

A final external cause of the decline of British power was the rise of nationalism, which helped to transform the empire from an asset into a liability. In 1914 London declared war on Germany on behalf of the entire empire. But long before post-Second World War anti-colonial nationalism stripped away Britain's Asian and African colonies, the "white" dominions of Canada, Australia, and New Zealand were resisting rule from London. By the time of the Chanak crisis with Turkey, in 1922, London had discovered that it could not count on automatic support from the empire. After 1926 British military planners no longer considered the British Commonwealth to be a reliable basis for military plans. Commonwealth forces were at best a possible bonus. Yet, as the British historian Corelli Barnett points out, in wartime the continued existence of the empire "would pump away from England the military resources she needed for her own war in Europe." American Lend-Lease in 1941 provided those resources, but by 1945 "British power had quietly vanished amidst the stupendous events of the Second World War."

THERE WERE ALSO IMPORTANT INTERNAL CAUSES of the decline of British power. Among the most important were the failure to maintain the productivity of British industry, particularly in new sectors, and to improve the nature and level of education. The two factors were related. British governing-class education was really appropriate to a moment in history that had already vanished, according to the economist Andrew Tylecote. Britons hardly thought at all of British power in terms of industrial competitiveness, science, technology, or strategy. The nation found the imperial alternative "more attractive than the 'industrial' one, because its upper class was dominated by a landowning aristocracy which set the tone for the rest."

While Britain continued to produce entrepreneurs who responded to market incentives, they focused on the staples of textiles, shipbuilding, and light industry rather than the new science-based industries. Britain failed to

invest in the latest technology in such critical new industries as chemicals, electricity, and precision engineering. As the British writer David Marquand has argued, "The most sophisticated sectors of the late-nineteenth and early-twentieth centuries depended far more on applied science. . . . It was in exports from these that Britain was most conspicuously outclassed." In 1913 Britain controlled two thirds of world exports of manufactures in declining sectors (like textiles), but only one fifth of world exports in expanding sectors (like chemicals). Until 1902 Britain had no public secondary-school system, despite public awareness of German educational superiority. Britain had seven universities, to compare with twenty-two in Germany and nearly 700 colleges and technical schools in the United States.

The increasing economic importance of overseas investment was transforming Britain into a rentier society, in which financial interests maintained an overvalued currency detrimental to British industry. Overseas investment rose from 0.2 percent to 5.2 percent of GNP from 1870 to 1913. By 1900 eighty percent of the capital issues on the London market were for overseas investment. By 1914 Britain owned 43 percent of the world stock of investment overseas. As the Nobel laureate Sir W. Arthur Lewis put it, "She could not pioneer in developing new

commodities because this now required a scientific base which did not accord with her humanistic snobbery. Instead she invested her savings abroad; the economy decelerated, the average level of unemployment increased and her young people emigrated."

Finally, Britain's domestic political process did not allow the full transformation of Britain's potential resources of power into effective influence. Aaron Friedberg convincingly shows that the problem was not complacency; concern about decline was widespread. At the turn of the century the press expressed concern that England lagged in scientific organization, applied technology, and worker training. But the debate was confused, with little agreement about what measures would be useful or what responses appropriate. While a return to primacy was impossible after 1900, and Britain did seek out new allies after the Boer War, the British elites could have done more to preserve Britain's position and to prepare for coming challenges.

British Conservatives, however, believed that Britain was financially stretched to its limit, and feared the economic effects of raising income taxes. They failed to invest in the forces needed to maintain global naval supremacy, and disguised that fact from the public by keeping the old slogans. Thus the empire became de

THE TONE

It wasn't a bell, it was a steady tone.
 We folded our papers and closed our books.
 Raised the wood lids of our metal desks.
 Books placed inside, pens lined neatly in the tray.
 Lunches taken out, necks of the brown bags
 rolled and sweaty in our fists. Mrs. Flint
 blowing the whistle that hung always around her neck.
 Lining, in alphabetical order according to surname,
 first name in the case of there being two Smiths,
 along the east wall, away from the windows.
 Us reciting our names, her checking the roster.
 Her opening the classroom door and us waiting
 for her to step to head the line. Shuffling forward
 like a many-legged worm. Peter Zeigler delegated
 to close the door and shut the lights. Merging
 behind homerooms 212 and 214, single file against
 both sides of the hallway, using banisters
 as we carefully descended the stairs. One flight
 then the next, turning into a basement corridor
 and a room without window or light. Each class

instructed to sit Indian-style on the floor.
 To press our faces into our open, knitted hands.
 To keep eyes closed. To wait.
 And the mindless way we executed our submission
 not running as we fled down corridors
 for our lives, not wriggling, not poking
 each other, not spitting or talking or committing
 small crimes of recess mayhem, not rehearsing our
 willful farts, not wadding our sandwiches into balls
 and winging them against the cinderblock, not
 asking to be let upstairs to pee or what to do
 when the flash came that would reveal to us
 the bones in our hands through our downed eyelids
 not asking what comes later not asking anything
 of proof or purpose beyond the insistent tone.

—Lucia Perillo

pendent on the good will of the new regional powers, the United States and Japan. Henceforth Britain had to avoid embroilment with more than one first-class power in more than one region of the world at a time. Furthermore, Britain did not implement conscription (as the other major European powers had done by 1872) or pay for an adequate army to help maintain the balance on the Continent in the new age of rail mobilization. The 1906 plan for 120,000 men to assist France proved woefully inadequate in 1914.

The British debate over trade was phrased in terms of the polar extremes of protectionism and free trade. Little attention was given to temporarily protecting critical sectors or forcing reciprocity on foreign markets. Colonial Secretary Joseph Chamberlain tried to rouse his Conservative colleagues to a more coherent response, but his protectionist scheme would have made things worse. Not surprisingly, it attracted the support of the least competitive elements of British industry. In any event, he wound up splitting his party. Prime Minister Arthur Balfour's moderate suggestion of selective retaliatory tariffs to force foreign markets open was lost in the ideological crossfire over free trade, and little attention was paid to the security implications of the British lag in the most modern sectors of industry.

Joseph Chamberlain was no more successful elsewhere in the security area. At a 1902 colonial conference he failed to persuade the colonies to share the burden of naval costs. His plaint that "the Weary Titan staggers under the too vast orb of its fate" did not pry forth new resources. Nor could he convince his colleagues that Britain's burdens were relatively light. In fact, the entire government budget was only 15 percent of GNP (in modern Britain it is nearly 45 percent). And although the Boer War created a deficit from 1899 to 1903, the budget was in surplus thereafter; the national debt in 1907 was not much higher than it had been in the 1880s. The historian A.J.P. Taylor estimates that Britain spent 3.4 percent of its national in-

come on armaments in 1914, while Germany spent 4.6 percent, France 4.8 percent, and Russia 6.3 percent. Other estimates place Britain ahead of Germany but behind France in its military burden.

So why did Britain decide that it could not afford to maintain naval supremacy or an adequate Continental expeditionary force? In large part because the adherents of the prevailing economic orthodoxy believed in the negative effects of government spending, and they particularly opposed raising income taxes. The popular belief that Britain was suffering from imperial overstretch—despite the lightness of Britain's defense burden, at three percent of GNP—prevented Britain from investing as well as it might have in the domestic and external resources of power which could have slowed decline.

Even if its leaders had played their domestic cards perfectly, however, Britain would have seen a significant decline in its power in the twentieth century. A.J.P. Taylor speculates that the impressive growth of German industry would have brought Germany to the mastery of Europe if it had not been for the First World War. The industrialization of America, Russia, and Japan was bound to shrink Britain's influence. Moreover, nationalism was soon to erode the empire. In a sense, Britain rose to its leading position because it was on the first wave of the Industrial Revolution in a pre-nationalist era. But it has always been remarkable that such a small

country in Europe could control a quarter of the world's people in the largest Western empire since Roman times.

How the United States Is Different

THERE ARE AT LEAST FOUR MAJOR DIFFERENCES in the positions of power held by Victorian Britain and modern America. The first is the degree of predominance. Britain's resources of power in the mid-nineteenth century were most impressive in naval force and manufacturing production. As the



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Harvard political scientist Robert Keohane has written, "Britain had never been as superior in productivity to the rest of the world as the United States was after 1945." Nor is the twentieth-century United States as dependent on foreign trade and investment as nineteenth-century Britain was. Even during its heyday, around 1875, Britain ranked third in military expenditure. Not only is the United States more powerful in more ways than Britain was but there are differences of scale that suggest that its power may persist longer. Today it requires a united Europe, not just a united Germany, to challenge the United States for global leadership. Britain, an island about the size of Oregon, ruled a quarter of the world. But, as we have seen, the empire quickly fell victim to nationalism and ceased to be a reliable basis for British military plans.

Second, at least since 1865 the United States has been a single, continental-scale economy immune to nationalist disintegration. Today American imports account for only 12 percent of GNP, in contrast to the British figure of 25 percent in 1914. At the peak of its power, in the 1870s, Britain's economy was only the third largest in the world, and it fell to fourth place in 1914. However, the American GNP today is much larger than those of the nearest competitor states. One should keep such differences of scale in mind when considering theories of overstretch.

Third, for all the loose talk (and looser definitions) of an American empire, there are important differences between Britain's territorial empire and America's areas of influence. Americans have more choice about types and levels of defense commitments than Britons had. There are more degrees of freedom for all parties. American trade is not drawn in the same degree to unsophisticated markets. By 1913 two thirds of British exports were going to semi-industrial and nonindustrial countries. Some modern historians argue that the territorial empire became a net drain on Britain. Whether one looks at NATO as a forward defense of American borders, in which Europeans provide

most of the manpower, or as an act of American generosity, it is hard to see our alliances constituting a similar drain, particularly since the withdrawal of American troops to home bases would save money only if the units were also disbanded. Unlike Edwardian Britain, which had to leave its isolation and cast about for allies at the beginning of the century, the United States at the end of the century must transform and update the successful alliances with the great industrial democracies which have been critical to the global balance of power for the past forty years.

A fourth major difference lies in the geopolitical challenges that the two nations face. Most important, in 1900 Britain faced rising contenders in Germany, the United States, and Russia. The nearest of those contenders, Germany, had not only surpassed Britain in economic strength but also was becoming militarily dominant and a threat to Britain's supremacy on the Continent. America's external situation today is different. Its principal military adversary, the Soviet Union, is the power with a bad case of overstretch. Not only is the USSR confronted with an unstable Eastern European empire, but the Soviet economy has suffered a serious deceleration of the growth that previously allowed expansion. In addition, Soviet defense is often estimated to cost 15 percent of GNP, and some estimates place the costs of defense and empire at more than 20 percent of GNP—about three times



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as high as the relative burden on the U.S. economy. The British analogy would be apt if Kaiser Wilhelm II's Germany, rather than passing Britain in economic and military strength, had been declining and looking for the chance to take a breathing spell from its military buildup.

None of the other major world powers is now overtaking the United States in both military and economic strength. Although Western Europe has a skilled population, a robust GNP, and the improved Common Market coming in 1992, few observers think that European integration will progress soon to a single government or a sin-

Leadership

gle security policy. Similarly, China might be a potential rival of the United States' over a much longer term, but China's human and technological infrastructure is much less developed than that of the United States or even the Soviet Union. And while many Americans believe that Japanese economic strength is a greater challenge than Soviet military power, economic competition is not a zero-sum game, where one country's gain is its competitor's loss. Thus far Japan has chosen the strategy of a trading state rather than of a military power. There is no current analogue to the Kaiser's Germany. Even a reunited Germany would possess an economy only one-fifth the size of that of the United States.

THE MORE INTERESTING COMPARISONS BETWEEN Britain and America lie in the domestic realm. Here there are legitimate causes for concern. Productivity growth in the American economy has fallen to an annual rate of 1.4 percent from an average annual rate of 2.7 percent in the first two postwar decades. In the 1980s net national savings fell to an all-time low of 2.0 percent, and gross investment, at 17 percent of GNP, was at only about half the Japanese level of 30 percent. Civilian research and development accounted for 1.8 percent of GNP, while in Germany and Japan it accounted for 2.6 and 2.8 percent. Foreign inventors received almost half the U.S. patents granted in 1987, as compared with a third a decade earlier.

Even here one should be wary of too simple comparisons to Britain. Whereas Britain fell behind in the leading sectors of chemicals and electricity at the turn of the century, the United States remains one of the leaders in such critical new sectors as information processing and biotechnology. The United States attracts capital from the rest of the world; Britain exported it. Further, whereas emigration drained talented Britons from their homeland, immigration continually infuses the United States with new labor and energy.

Perhaps the most interesting domestic comparison, however, is political. Will the United States cope both with its international commitments as the nation that other nations look to for leadership and with its need for domestic reforms? The British experience suggests caution. The political processes of Victorian democracy tended to fragment the national debate. Conservative politicians failed to invest adequately in the future. There was a widespread reluctance to raise the level of taxation, which was low. Here the analogy with modern America becomes more apt: the United States is the world's richest country, but it acts poor. Although America is one of the most lightly taxed of the industrial countries, the American public seems unwilling to invest adequately in the future, and political leaders have done little to stem the flow of resources from investment to consumption in the 1980s.

EVEN A STRONG ECONOMY WILL NOT PREVENT the United States from following foolish policies. Political leadership is necessary to explain why certain policies—whether these are budget deficits, protectionist measures, or the curtailment of foreign aid—can lead to self-inflicted wounds. Effective influence requires a willingness to spend on foreign affairs. Despite a doubling of the national economy from 1960 to 1980, by the latter year the United States was spending less in real terms on elements of the budget directly concerned with foreign affairs: defense, foreign aid, information, and representation. Defense expenditures increased in the 1980s, but American outlays for other aspects of international affairs declined from \$12.7 billion in 1981 to \$10.5 billion in 1988. This reduction flies in the face of the growing importance of economic, information, and institutional resources in maintaining or creating national power. Some might ask why we should invest in power. Why not simply consume happily, like the Swiss or the Swedes? The answer, of course, is that the United States is too large to take a free ride in the international system. It is in this country's interest to exercise an influence in the world commensurate with its size and its stake in the spread of open societies—which is to say, those that respect human rights—and open economies. It is important to emphasize that such leadership is a function primarily of size, not of America's hegemonic mission to lead the world. Leadership is not hegemony. It means taking responsibility for one's long-term political and economic interests.

"We can't afford it" is the typical argument in a time of budget deficits, whether it is aid to Poland, investment in education, or fighting drugs. But if the United States were to follow policies that cut domestic consumption by the two percent of GNP by which it rose in the past decade, the richest country in the world could afford both better education at home and the international influence that comes from an effective aid and information program abroad. What is needed is increased investment in "soft power," the complex machinery of interdependence, rather than in "hard power"—that is, expensive new weapons systems. As the Republican economist Herbert Stein remarks, "It is time to ask the 86 percent of the American people who are not poor to give up some small part of the increase in their consumption in order to fortify the national security, to provide more adequately for the future growth of the national income, to improve the lot of the poor among us."

At home, leadership means pointing out that the American economy can easily afford to invest in international affairs—by paying our dues to international institutions, by providing aid to critical countries like Poland, and by maintaining open international markets—if Americans have the political will to do it. Without such

leadership the American ability to convert potential power into actual influence is correspondingly diminished. A leader who wishes to maintain American power at the turn of the century must follow a strategy that rebuilds the domestic bases of American strength while also investing resources to maintain international influence. Both elements are necessary.

Although the United States faces major social, economic, and political problems, it has faced equal or larger problems in the past. One key to coping successfully with these problems is to remain open to the outside world and adaptable to change. Social flexibility, class fluidity, and economic openness are advantages that America has over Europe and Japan. It would be ironic if fears of decline led to policies of protectionism, resistance to foreign investment, and curtailment of immigration. Though there are few signs of long-term economic sclerosis so far, such policies could help to bring it on. Then again, if the anxiety over competitiveness leads to new policies on saving, research and development, and education which are addressed to the higher standards required by an information-based economy, America's capacity to reinvent itself may again prove a hidden strength.

AMERICANS ARE right to be concerned about the changing role of the United States in the world. However, seeing the problem as American decline and drawing analogies to Britain is misleading, for this directs attention away from the real problems arising out of long-term changes in world politics and suggests remedies that would weaken rather than strengthen America's standing. Withdrawal from international commitments would reduce U.S. influence without necessarily strengthening the domestic economy. Indeed, recent experience suggests that what the United States thereby saved in international expen-

diture might merely increase domestic consumption rather than investment.

Although the next decade will require Americans to cope with the debts of the 1980s, there is no reason why the world's wealthiest country cannot pay for its international commitments *and* its domestic investments. Americans can afford both social security and international security. The ultimate irony would be for Americans to perceive their country's short-term problems as indicators of long-term decline and respond in a way that cut them off from the sources of their international influence.

As has happened many times before, the mix of resources that produces international power is changing. What is unprecedented is that the cycle of hegemonic conflict, with its attendant world wars, may not repeat itself. The United States at the end of the century retains more traditional resources of power than any other country has. It also has the ideological and institutional resources to retain its leadership in the new domains of transnational interdependence. In that sense the U.S. situation at the end of the twentieth century is totally different from that of Britain at the century's beginning. The problem for American power today is not new challengers for hegemony; it is the new challenge of transnational interdependence.

A post-Cold War strategy for managing the transition to complex interdependence over the next decades will require that the United States

commit sufficient resources to sustain the geopolitical balance, maintain an open attitude toward the rest of the world, develop new international institutions, and restore the domestic sources of American strength through major reforms and large-scale investments. The twin dangers Americans face are complacency about the domestic agenda and an unwillingness to pay whatever is necessary to maintain their capacity for international leadership. Neither attitude is warranted. □



IF THE ANXIETY OVER COMPETITIVENESS LEADS TO NEW POLICIES ON SAVING, RESEARCH AND DEVELOPMENT, AND EDUCATION, AMERICA'S CAPACITY TO REINVENT ITSELF MAY AGAIN PROVE A HIDDEN STRENGTH.

3-12

Remarks by Michael J. Boskin
at the City Club Forum
Wednesday, March 7, 1990

Thank you for that kind introduction, Elizabeth. It is indeed a pleasure to be here at the City Club of Cleveland. It's something we've been trying to arrange for a several years. I'm delighted to be here and I thank you for your gracious hospitality. The City Club of Cleveland, as I understand it, has been providing a public speaking forum free speech and expression for more than three quarters of a century. You are to be commended for that impressive achievement, and when I look down the list of people who have spoken here, it is enormously impressive. Among your previous speakers is my boss, the President of the United States, who has spoken here on five separate occasions. Your Director, Alan Davis, tells me that he was not only a classmate of President Bush at Yale, but played on the same baseball team. The only thing I've not managed to learn is what Alan's batting average was at Yale. (comment from the audience--"It was better than the President's") I won't repeat that when I go back to Washington. So it's a pleasure to be here and see some old friends and make some new ones. I have learned a lot about Cleveland. It's the home of the Rock and Roll Hall of Fame. It is also the home of a terrific football team which almost made it to the SuperBowl. And I suppose the Denver Broncos wished that the Browns had made it to the SuperBowl.

Let me try to do three separate things that are closely related. First, give you my perspective--as the President's

economic adviser--about where the United States economy is, how it got there, and where it's going. Second, give you some perspective on what the Administration is trying to accomplish--the goals and principles of economic policy to promote an improved standard of living for Americans. And third, let me share with you some experiences, some intellectual excitement and just some plain wonder at the events of the last year, particularly those in Eastern Europe.

Let me begin there. The Berlin Wall is coming down, and freedom is rising up. Eighteen months ago I was a professor teaching principles of economics--the beginning economics course--to freshmen at Stanford University. Now I find myself teaching principles of economics to Prime Ministers and Finance Ministers from Eastern European countries, whose newly emerging societies are trying to make the painful and important steps to market-oriented economies, bringing the hope of a better economic life to their citizens. What has happened is simply extraordinary what has happened--on a personal, societal, and global scale.

But I want to begin by making some very simple statements of fact about the American economy. I wish to do so because we hear an amazing amount of negative news and information, and I think we have to just set the record straight.

First the American economy is the largest, most productive economy in the world. With less than 5 percent of the world's population, we produced well over a quarter of the total output, GNP, in the world.

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Our economy is 2-1/2 times the size of the next largest economy, which is Japan.

The average standard of living of Americans--GNP per capita--is far above that of those in other major industrialized economies--fully one-third higher than that in West Germany or Japan. We start from a position of great strength.

Second, we're in the 87th month of the longest peacetime expansion in the entire history of the United States. (To be a little more accurate, the data only go back to 1854--economic historians tell me it's unlikely we had this long an expansion between 1776 or 1789 and 1854.) Some people say that because an expansion is long, it must end soon. There is no economic theory and no empirical evidence for that view. Economic expansions do not come with a pre-set expiration date. The economy has been growing more slowly starting in late 1989, but we expect it to improve as this year progresses.

In this expansion--which started at the end of 1982--we've created 21.6 million jobs in the United States. That's far more than the jobs created in all the advanced economies of Western Europe, Canada, and Japan combined, despite the fact that they have combined a much larger population than do we.

Personal incomes--after adjusting for inflation and taxes--have risen substantially.

The unemployment rate has fallen substantially. Exports, which were a major problem the earlier part of this decade, have risen. Productivity growth, which had been virtually nonexistent

most already in

in the 1970s has rebounded partway to the robust levels of the 1950s and 60s, especially in manufacturing. And we've set the stage in a long expansion by preventing inflation from accelerating for the first time in any expansion since World War II for better times ahead for continuing this expansion and a better decade in the 1990s.

Let's take a look at 1989, a year in which economic growth slowed to around 2.5 percent from more rapid growth in 1987 and 1988. We added another 2.5 million jobs.

Exports rose to an all time high--\$589 billion. The United States once again became the world's leading exporter.

Real disposable income, income after taxes and inflation, rose 3.6 percent last year.

The unemployment rate averaged for all of 1989 5.3 percent. It also ended the year at that level and is at that level today--a rate we hadn't seen since the early 1970s. And those job opportunities have spread widely. The unemployment rate for blacks is the lowest since the early 1970s; for teenagers, the lowest since the early 1970s; for Hispanics, the lowest since we started keeping separate data for Hispanics in 1980--and undoubtedly for a considerably longer span of time than that. Women have made major economic progress in the last six or seven years. The unemployment rate for women has been no higher than the unemployment rate for men for the first time since World War II. And at a time when many more women entered the labor force,

and were able to find jobs, about a quarter of the pay gap between men and women was eliminated.

Those are impressive achievements. That's a strong economy growing stronger. I'll come back to the short-term and longer-term prospects and what we need to do to keep our economy growing to provide rising living standards for our population in a moment. But I want you all to mull those facts, because somehow in the general discussion of where we are in the United States, they're not getting out there.

We cannot, however, take continued economic growth for granted. We cannot become complacent. The Administration's foremost priority is to sustain the highest possible rate of economic growth. That isn't just an abstraction. Economic growth requires movement on many fronts, but it makes action on many more social and private goals attainable. Economic growth is how we create rising standards of living for the bulk of the population. How we develop the resources to uplift those most in need. How we provide economic and social mobility to our citizens. How we leave a better legacy to our children. And how we maintain America's leadership in the world. Thus, our primary priority is to make sure we achieve the highest possible sustainable rate of growth of the economy's potential output and make sure the economy operates at its potential, not below it. We've establish some principles that we use in the Administration to try to achieve these goals. In our system of checks and balances and divided system of government, it is not just the

Executive Branch that sets economic policy. Congress has a major say in a variety of areas. We have an independent Federal Reserve, and so on. But let me just say a word or two about our principles with some examples. Our principles for monetary, fiscal, trade and regulatory policy are designed to make sure that the private sector of the economy--the engine that drives growth--will continue to create jobs, expand opportunities, increase productivity and provide greater opportunities for Americans.

We support a monetary policy by the Federal Reserve that sustains growth, while predictably controlling inflation.

Our budget policy is directed to turn the tide, to take the Federal Government which for too long now has been a chronic borrower draining the Nation's scarce saving pool, thereby raising interest rates and the cost of capital to our businesses, dampening investment and detracting from economic growth, into a supplier of capital to the U.S. capital market by protecting the integrity of the projected social security surpluses, moving toward a balanced budget outside the social security system, and freeing up resources with those projected social security surpluses to reduce the national debt, lower interest rates, expand investment, spur economic growth and a raise standards of living.

It's not just the size of the deficit that determines the fiscal contribution to economic growth. It's also how we tax, and how wisely and well we spend. And there we have some

principles as well. We believe we need a tax system that gets out of the business of distorting incentives to the private sector of the economy; make sure that we maintain incentives to invest, to innovate, to save and to work. We support the principle of low tax rates on a broad base that was enacted in 1981 and extended in the tax reform of 1986. We see some problems with our tax code, in particular on some of the capital formation issues. We have a research and experimentation tax credit which is renewed every year by the Congress. Research and development is a long-term process and if you're going to get an idea, innovate, develop a product, bring it to market, it's going to take a lot more than one year's tax credit to get you to do that innovation. We want to make that R & D tax credit permanent. We believe that a capital gains rate reduction restoring a differential for capital gains will spur entrepreneurial activity, increase risk-taking, and investment, spur economic growth, create new industries, new jobs, and help revitalize important sectors of our economy. There are those who argue that this is a tax break for the rich. That's a silly way to look at it. This is not a rich/poor issue; it's an America issue. It's investing in the growth of our economy.

We've proposed an innovative new tax incentive for family saving for pre-retirement objectives that respects the need not to worsen the budget deficit.

We also believe in carefully targeted tax incentives to help people in need. For example, in day care. There are those who

propose a vast new middle class bureaucracy-controlled, state-run or mandated day care system with no flexibility or choice for parents. We think that's unwise. We think the role of the Federal Government should be to target those funds to the people at the bottom, those most in need to provide them the opportunity to enter the marketplace successfully, earn a living, get on that ladder of opportunity, and we want to do so in a manner that gives them dignity and choice about how to do it.

On the spending side, its not also just how much the Federal Government spends (and it does spend a lot--\$1-1/4 trillion is what we propose for next year). We're being criticized for not proposing enough. Yet, that's more than the entire GNP of all but a few countries. We're trying to tilt that spending more toward investing in the future. The Federal Government must finance basic research and development because no private firm has an incentive to undertake research which would be broadly applicable, as all the returns would not be privately appropriable. So we propose a record high R & D budget of \$70 billion.

We think we should be spending a lot more on preparing disadvantaged children for effective learning and have proposed a \$500 million expansion of Head Start. We think we should be spending more on improving aviation infrastructure and have so proposed, and I can go on and on.

But we don't think we ought just to spend money on problems. We believe that many national problems do not require Federal

spending, but may require Federal leadership to galvanize the nation. A very good example is our elementary and secondary education systems. This is an immensely important concern for the future of our economy, as well as the simple decency of quality education for our children. We face an increasingly competitive world economy--an economy where in the future our workers are going to need more skills and the ability to learn new skills throughout their lifetimes. And yet we see international comparisons on test after test that the performance of the kids in our elementary and secondary schools is not stacking up. The United States total spending per pupil on K through 12 education is more than any other industrialized country except Switzerland. We are not getting our money's worth. We need to change the focus from how much we spend to what we get out--to the performance of our kids. Now there may be times where spending more is necessary, whether at the Federal level, for example for Head Start to prepare disadvantaged children for effective learning, or at the state and local level, but that should not detract from the more fundamental issue: we need a fundamental restructuring of our education system.

We simply cannot remain a great nation, a growing, vital world leader, with a second-class elementary and secondary education system. So the President--for only the third time in the history of the United States--called the nation's Governors together last September in Charlottesville to work to establish national performance goals for education. And these were

announced last week in Washington by the President and the Nation's Governors. A bipartisan effort--a fiscally Federal effort, the Federal Government and the Nation's Governors, and we are going to turn now to galvanizing the Nation to achieve these goals--every student, every family, every school district, every PTA, every Principal, every teacher, every parent, every school board, every mayor and every Governor, as well as the Federal Government.

In regulatory, legal policy, trade policy and the like, we have similar goals. In regulatory policy, we want to avoid unnecessary regulation, and deregulate where possible, for example, natural gas at the well-head which we did last year. But there are some areas where regulation is necessary--the environment, for example. And there we try to achieve a sensible balance between the need for a healthy environment and the prerequisite of a sound, growing economy. There are those who argue that a healthy environment and a sound economy are incompatible. Extremists on both sides of that equation do not believe that we can reconcile the needs of an improved environment and a strong economy. I reject that notion. It will be costly to clean up the environment. There is no free lunch. But it can be done in a way that is cost-effective, that gives workers and firms flexibility in achieving those improvements, that does not force plants to shut down and workers to lose their jobs because some bureaucrat in Washington sets a silly rule that isn't applicable to a local situation. And we are working very

aggressively with Congress to try to achieve landmark Clean Air legislation that accords to these principles; a strong move toward a healthier environment, but in a way that provides maximum flexibility to firms and workers to minimize economic costs to achieve those standards.

In trade policy, much attention has focussed recently on trade frictions the United States has with various countries, but especially Japan. The world's economic growth--that of the United States, that of Japan, and most importantly, that of the newly developing economies--has benefitted more than anything else from the move toward an open liberalized world trading system since World War II. It would be shortsighted and foolish at best, dangerous at worst, if we don't press forward to open markets everywhere and instead turn to closing them. We cannot become more competitive by choosing not to compete. We need to open markets, not close them. We need to press forward to lead the world to freer and fairer trade, and we ask all other nations to join us in that effort. Our primary objective, through the Uruguay Round of the General Agreement on Tariffs and Trade, is to bring fifteen areas which are not currently well covered by our rule-based international trade system into that system, to decrease those frictions and open markets world-wide.

Those are our principles. We believe that with those principles, we fashion an important growth agenda. That growth agenda means that we must invest more and more wisely. I've mentioned at some of those kinds of investments, but let me just

summarize. We must invest more in intellectual capital, in research and development. That means more Federal spending, as we have proposed on those basic scientific breakthroughs that no single firm could hope to finance and generate enough return from because the benefits will accrue so widely. It means a better environment for private entrepreneurial and innovative activity with the capital gains tax rate cut and the permanent R & D credit and other legal and regulatory reforms such as a better-balanced system of product liability laws.

We need to invest more in tangible capital--in our factories--in machines--and we must to make sure they are up to date and equip our labor force with the best quality available.

And we need to invest more in our human capital. I've stressed elementary and secondary education. We are also working in innovative ways to try to eliminate adult functional illiteracy.

It is only by attacking all those determinants of our long-term growth that we have the best chance of making sure that our economy continues to grow, providing a rising standard of living for our population, retaining the flexibility and dynamism that are its hallmarks, the foundation to continued economic leadership.

Let me return finally to say a word or two about the remarkable changes in Eastern Europe. We have seen a movement to pluralism and democracy and toward a market-oriented economy in many of the countries of Eastern Europe. Yet there is a lot of

variation among them--some are further along; some have not made many decisions, some are in the process of making them. This is one of the most remarkable events of our time. I said before I had been teaching principles of economics at Stanford. And in that course, it is standard to spend a few days talking about the centrally-planned, so-called command economies of the Soviet-type in which Commisars, bureaucrats centrally plan what is produced, and who works where. Instead of the economy producing what people want, the people get what the central planners want them to have. And in economics courses all throughout the country, our students are taught how that system not only supresses freedom of choice and opportunity, but that it just can't deliver the goods. Well, I admit like everybody else, that I was surprised by how rapidly these changes occurred. I always thought they would, and I am delighted they have. We have made a commitment, in conjunction with our allies, to provide some assistance, some food aid, some financial assistance, some technical assistance, but it's going to be a while before those economies straighten themselves out. Many of those countries haven't decided exactly what model they would like to follow. Whether they want to become as market-oriented as the United States, or far less market-oriented is still being decided. All those economies start after four decades of repressive central planning from very low standards of living, and while the great hope they have is that with the freeing up of resources and the market orientation that they are adopting they can get onto a

highway to prosperity, they are going to be navigating bumpy congested city roads while they get there. And so I think we need to have not only a perspective of hope, optimism and support for the peoples of Eastern Europe, but we also must temper it with a proper sense of perspective. For example if Poland achieves 4 percent real growth, it would take close to a half century to catch up to where the United States is today. So they have a long way to go. They are very bravely beginning to adopt some remarkable changes, but precious few of the citizens of these countries have experience or expertise--at the most fundamental level--about working, producing or consuming in a market-oriented economy. We need by example, by interchange, by good will as well as financial support, to provide them an opportunity to make that difficult transition.

I've laid out some of our principles, some of our policies, some of our perspectives. I hope you will let us know when you think we are doing a good job in achieving them. I hope you will let us know when you disagree with them. And I hope you will a special effort to keep me informed of how things are going here and how you see the kind of job we are doing in Washington to try to guarantee that our economy continues to grow and prosper.