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November 26, 1991

INPUT AND OUTPUT IN MEDICAL CARE

Dear Colleague:

We are pleased to distribute today Nobel Laureate Milton Friedman's paper "Input and Output in Medical Care" as the second in a series of Health Care Briefing Papers. Dr. Friedman details the deleterious effects of governmental intervention in the U.S. market for medical care and provides a compelling case for reprivatizing health care. Without endorsing any specific health reform, we put this paper forward as deserving serious consideration.

This analysis provides a long-term perspective on the medical market, focusing particular attention on inputs and outputs since the introduction of Medicare and Medicaid in 1965. Of particular note:

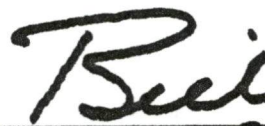
- There has been a dramatic rise in the number of hospital personnel and the cost of hospital services, while at the same time the number of beds was declining and the rate of occupancy is lower than in 1940. Dr. Friedman uses this as an example of what he calls "an economic black hole" -- resources are sucked in and output nonetheless shrinks.
- The study shows that based upon long-term trends in private, public and total spending, in the absence of Medicare and Medicaid, total health care spending would be half as much as it actually is today.
- Further, the sudden slowdown in the rate of increase in the life expectancy of women is nearly coincident with the massive infusion of government in the health care market and is, as far as we can tell, an unreported phenomenon that bears further examination.
- Dr. Friedman suggests that returning the medical market to the private sector by returning responsibility to the individual for the financing and provision of health care by (1) requiring each family to have medical insurance and (2) ending the tax exemption for employer-provided medical care would go far toward curing the ills of this market.

An abridged version of Dr. Friedman's study appeared in the November 12, 1991 edition of the Wall Street Journal. We distribute the original paper with their permission. We are sure that you will be interested in this original unedited text of the study, complete with additional charts. In future health care policy debates, we would do well to consider the insights presented by Dr. Friedman.

Sincerely,



DICK ARMEY
Ranking Republican
Joint Economic Committee



WILLIAM V. ROTH
Senior Republican Senator
Joint Economic Committee

HEALTH CARE BRIEFING PAPER

November 26, 1991

NO. 2

Released by Richard K. Armev (R-TX),
Ranking Republican, and William V. Roth (R-DE),
Senior Republican Senator, Joint Economic Committee

INPUT AND OUTPUT IN MEDICAL CARE*

by Milton Friedman, Senior Research Fellow, Hoover Institution

Some years ago, I came across a study by Dr. Max Gammon comparing input and output in the British socialized hospital system. He took the number of employees as his measure of input and the number of hospital beds as his measure of output. He noted that long waiting lists for hospital admission assured that all beds were in use so that the total number of beds could be taken as equal to the number of occupied beds. He found that input had increased sharply, while output had not only failed to keep pace but had actually fallen. He was led to enunciate what he called "the theory of bureaucratic displacement." In his words, in "a bureaucratic system ... increase in expenditure will be matched by fall in production.... Such systems will act rather like 'black holes,' in the economic universe, simultaneously sucking in resources, and shrinking in terms of 'emitted' production."

I have long been impressed by the operation of Gammon's law in the U.S. schooling system: input, however measured, has been going up for decades, and output, whether measured by number of students, number of schools, or even more clearly, quality, has been going down.

The recent surge of concern about the rising cost of medical care, and the flood of proposals to do something about it, most involving a further move toward the complete socialization of medicine, reminded me of Gammon's study and led me to investigate whether his law applied to U.S. health care.

There has clearly been a major advance in medical care in the past half century, from which most of us have greatly benefitted: indeed, I would not myself be alive today if it were not for some of those advances. Yet the question remains whether these gains were promoted or retarded by the extraordinary rise in the fraction of national income spent on medical care. How does output compare with input?

**An abridged version of this paper appeared in the November 12, 1991 Wall Street Journal. This original text, including charts not previously published, is printed with the permission of the Wall Street Journal.*

1. Hospitals

Even a casual glance at figures on input and output in U.S. hospitals indicates that Gammon's law has been in full operation for U.S. hospitals since the end of World War II, and especially since the enactment of medicare and medicaid in 1965.

Before 1940, input and output both rose, input somewhat more than output, presumably because of the introduction of more sophisticated and expensive treatment. The cost of hospital care per resident of the U.S., adjusted for inflation, rose from 1929 to 1940 at the rate of 5 percent per year. The number of occupied beds, at 2.4 percent a year (see Table 1). Cost per patient day, adjusted for inflation, rose only modestly.

Table 1 -- Summary Data on Hospitals and Medical Expense, Selected Years, 1923-1989

| | 1923 | 1929 | 1940 | 1946 | 1965 | 1989 |
|---|-------|----------|----------|----------|----------|------------|
| Beds per 1,000 population | 6.8 | 7.5 | 9.3 | 10.3 | 8.8 | 4.9 |
| Percentage of beds occupied | 73.0 | 80.0 | 84.0 | 80.0 | 82.0 | 69.6 |
| Cost per patient day in constant (1982) dollars | | \$18 | \$22 | \$21 | \$71 | \$545 |
| Personnel per occupied bed | | | | 0.7 | 1.4 | 4.6 |
| Hospital expense as percentage of total medical expense | | 17.8 | 24.3 | 24.0 | 32.1 | 35.6 |
| Medical cost per person per year in constant (1982) dollars | | | | | | |
| Hospital | | \$30 | \$52 | \$63 | \$190 | \$683 |
| Other | | \$143 | \$164 | \$200 | \$403 | \$1,237 |
| TOTAL | \$136 | \$173 | \$216 | \$263 | \$593 | \$1,920 |
| Physicians | | | | | | |
| Number per 100,000 population | 130 | 125 | 133 | 135* | 153 | 252** |
| Median income*** | | | | | | |
| Constant (1982) dollars | | \$21,722 | \$23,191 | \$34,407 | \$82,391 | \$99,016** |
| Ratio to per capita income | | 5.1 | 5.2 | 6.6 | 10.7 | 9.1** |

*1949.

**1987.

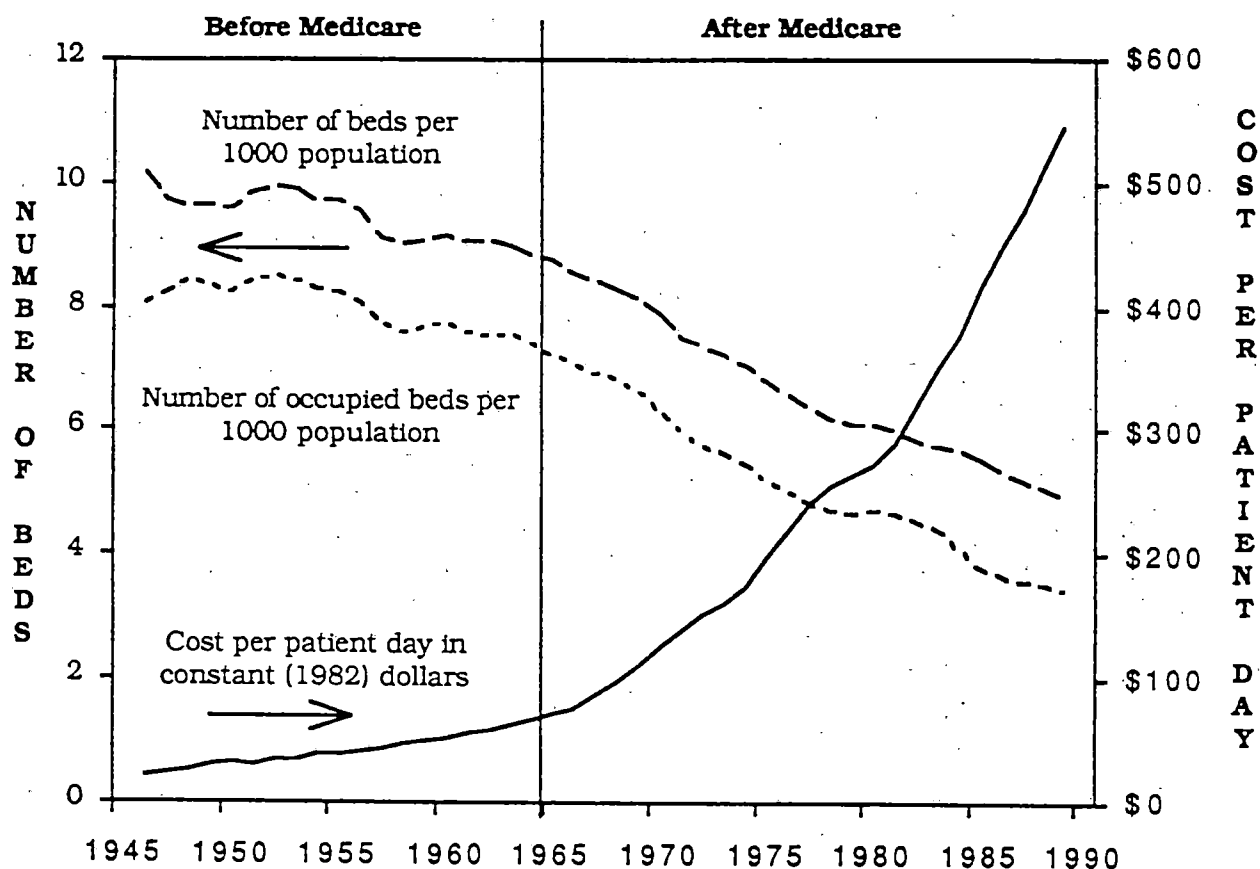
***"Non-salaried physicians" through 1965; "incorporated and unincorporated" in 1987.

The situation was very different after the war. From 1946 to 1989, the number of beds per capita fell by more than one-half, and the occupancy rate, by one-eighth. In sharp

contrast, input skyrocketed. Hospital personnel per occupied bed multiplied nearly seven-fold and cost per patient day, adjusted for inflation, an astounding 26-fold, from \$21 in 1946 to \$545 in 1989 at the 1982 price level.

Figure 1, which charts postwar data year by year, is a dramatic portrayal of the effect of the enactment of medicare and medicaid on both input and output.¹ A mild rise in input was turned into a meteoric rise; a mild fall in output, into a rapid decline.

Figure 1 -- U.S. Hospitals: Input vs Output, 1946-1989



Taken by itself the decline in the number of occupied beds could be interpreted as evidence of the progress of medical science: the population is healthier, needing

¹ Because the scales are arithmetic, the percentage rate of decline in output is understated, and the percentage rate of rise in input, overstated. However, the percentage rate of growth of input, like the absolute, did speed up after medicare -- from 6 percent per year before medicare to 9 percent after, according to exponential trends fitted to hospital costs per patient day for 1946-1964 and 1965-1989, respectively.

hospitalization less, and advances in science and medical technology have reduced the length of hospital stays, and enabled more procedures to be performed outside the hospital.

That may well be at least part of the reason for the decline in output, perhaps a major part. But it does not explain much, if any, of the rise in input. True, care has become more sophisticated and expensive, and medical machines more complex. Yet improvements in health and in the quality of hospital care do not appear to have proceeded more rapidly after 1965 than before. Indeed, there is some evidence that the reverse was true. Reported expenditures on research (as with other data, per capita and in constant dollars) rose at the rate of 15 percent a year from 1948 to 1964, at less than 2 percent a year from 1965 to 1989. Yet the number of occupied beds per capita fell by 1 percent a year from 1946 to 1964, and by 2.5 percent a year from 1965 to 1989. Cost per patient day rose by 6 percent in the first period, 9 percent in the second.

Gammon's law, not medical miracles, was clearly at work. The Federal government's assumption of responsibility for hospital and medical care for the elderly and the poor provided a fresh pool of money, and there was no shortage of takers. Personnel per occupied bed, which had already doubled from 1946 to 1965, more than tripled from that level after 1965. Cost per patient day, which had already more than tripled from 1946 to 1965, multiplied a further eight-fold after 1965. The difference between the rise in personnel and costs reflects expenditures on expensive equipment and higher prices for medical personnel relative to other goods. Growing costs, in turn, led to more regulation of hospitals, further increasing administrative expense. Unfortunately, I have been unable to uncover comprehensive and readily available data for a sufficiently long period to judge how large a role was played by increasing administrative costs. Anecdotal evidence suggests that increased administrative complexity played a major role in the explosion of total cost per patient day, and led to a shift from hospital to outpatient care, accelerating the decline in occupied beds.

Experts in medical care and in hospital administration can doubtless expand this amateur's explanation and put flesh on the stark evidence from the limited statistical data. But a fuller description is hardly likely to alter the bottom line: in Gammon's words, "a bureaucratic system ... will act rather like "black holes," in the economic universe, simultaneously sucking in resources, and shrinking in terms of 'emitted' production."

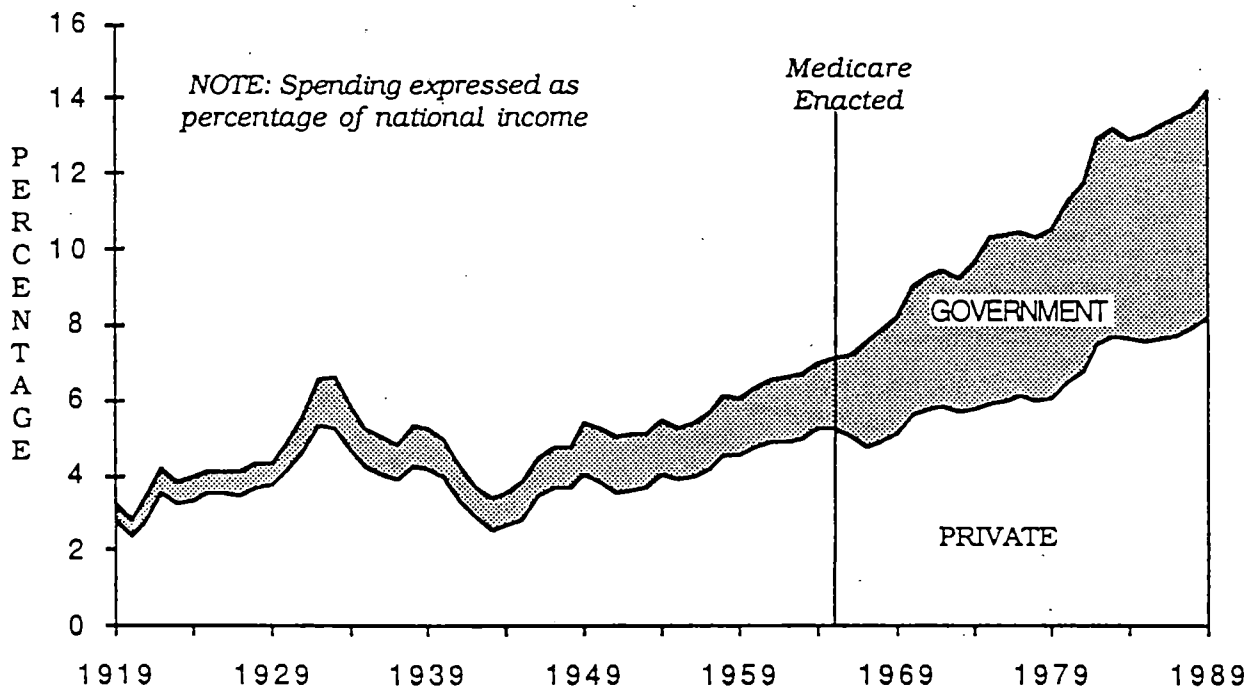
2. Other Medical Care

Though hospital cost has risen as a percentage of total medical cost from 24 percent in 1946 to 36 percent in 1989, it is still a minor part of total medical cost. It is tempting to apply Gammon's analysis to total medical cost rather than simply to hospital care.

There is no problem about input. Estimates of expenditures on medical care are readily available for the postwar period, can be estimated back to 1919, and can be corrected readily for the rise in population and in the price level.

Figure 2 shows total health spending as a percentage of national income from 1919 on, and its division between private and governmental spending. Except for the Great Depression, when the collapse of incomes raised the percentage sharply, health spending rose gradually but stayed between about 3 and 4 percent of total national income. Government spending was only a modest part of that total and was primarily state and local rather than Federal. For example, in 1940, Federal spending was about one-sixth of total government spending on health care. After the war, total spending on health care tripled as a fraction of national income and government spending, particularly Federal, became a larger and larger fraction of the total.

Figure 2 -- Health Spending as Percentage of National Income: 1919-89



Figures 3, 4, and 5 present the same data in a somewhat different way, as dollars per capita in constant prices. Private spending rose at a steady arithmetic rate up to the end of World War II, increasing by \$3.30 a year, with only minor deviations as a result of cyclical forces. The increase reflected mostly the long-term increase in income. As a percentage of national income, private spending stayed between 3.5 and 5 percent from 1922 to 1958 except for some of the depression years. From 1958 on, private spending began to rise as a percentage of national income, at first slowly, then more rapidly, reaching more than 8 percent by 1989.

Figure 3 -- Private Health Spending, 1919-89, and Linear Trend Fitted to 1919-40

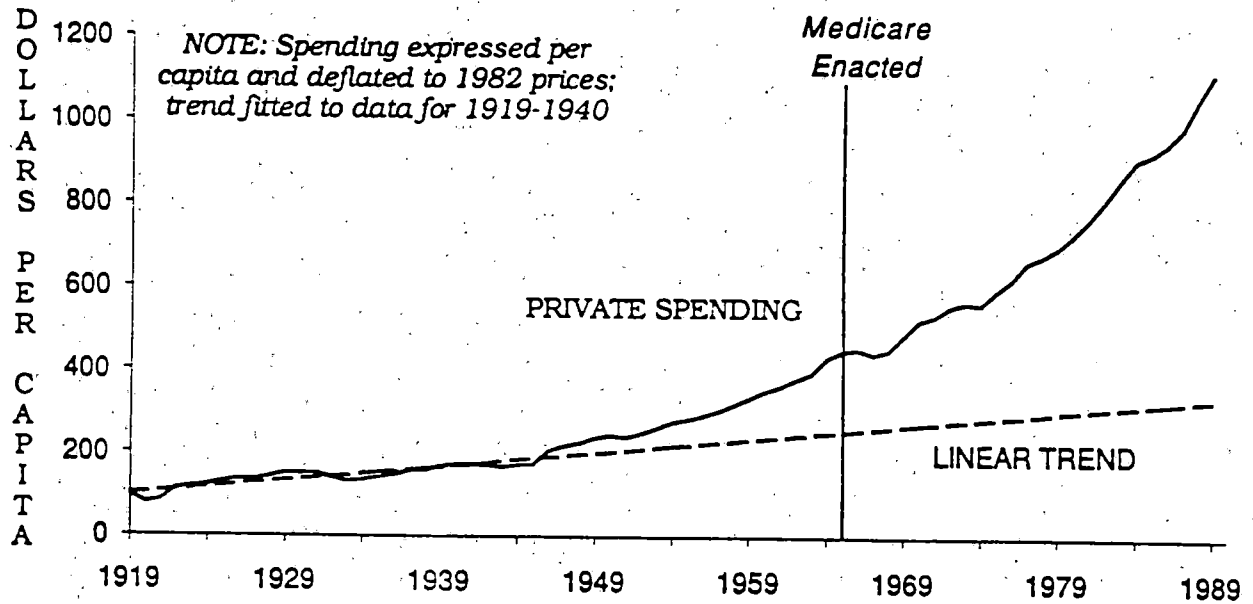


Figure 4 -- Government Health Spending, 1919-89, and Long Trend Fitted to 1919-40

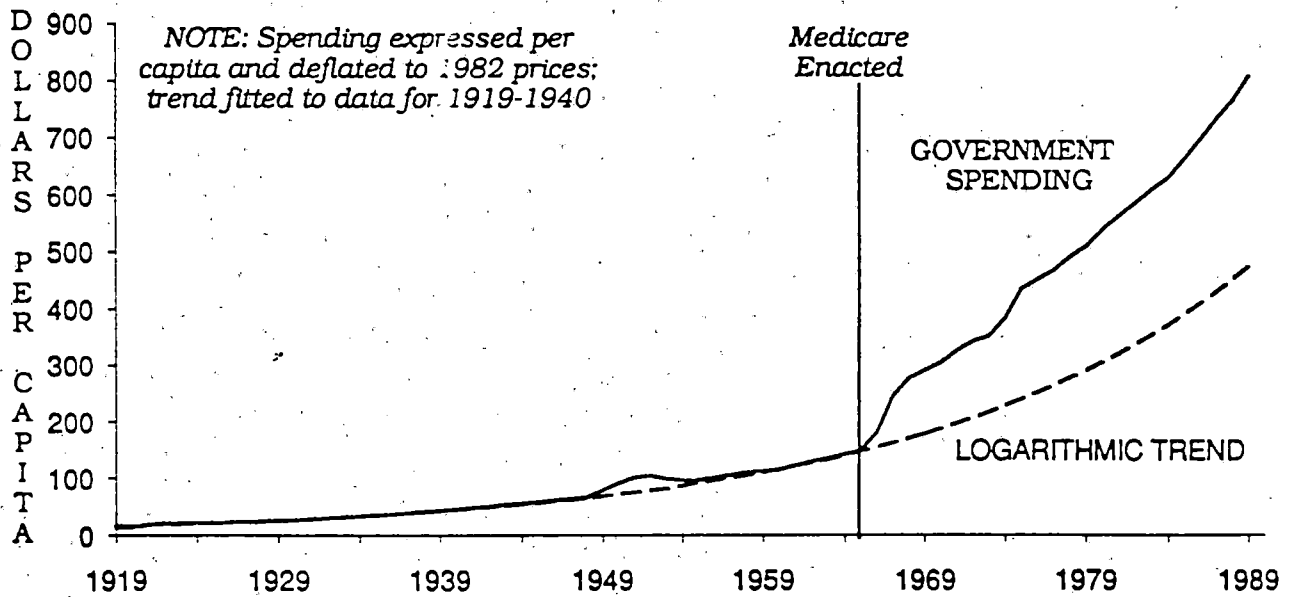
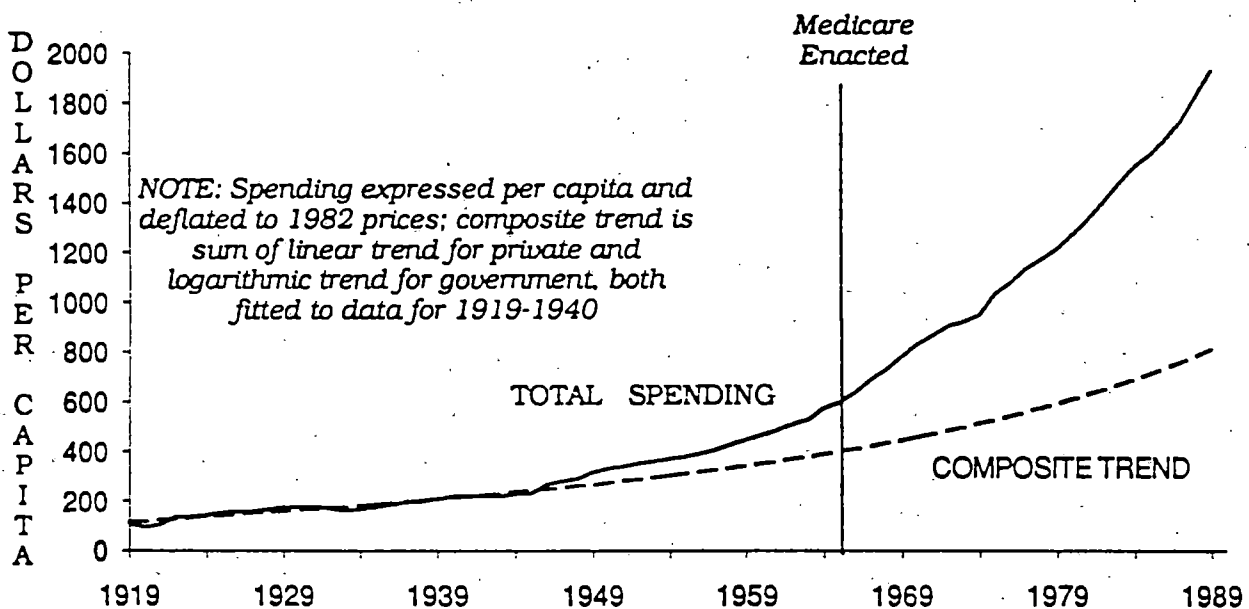


Figure 5 -- Total Health Spending, 1919-89, and Composite Trend Fitted to 1919-40



Government spending behaved somewhat differently. It rose at a rather constant percentage rate, 3.5 percent a year, from 1919 all the way to 1965, except for a short postwar bulge. The enactment of medicare and medicaid produced an explosion in government spending, which went sharply higher than the extrapolated trend. In the process, government's share of total spending went from 15 percent during the 1920s to 25 percent in 1965, before surging to 42 percent in the next two decades, or from less than 1 percent of national income to nearly 6 percent.

Figure 5 combines the data from the two prior charts. As it shows, if the prior trends had continued, total spending in 1989 would have been about half as much as it actually was.

One major physical input is the number of physicians. Physicians numbered 157 per 100,000 population at the turn of the century, gradually declined in number to 125 by 1929, and then rose slowly to 133 by 1959 before beginning an exponential climb to 252 by 1987, the latest year for which I have data. As the final line in Table 1 indicates, the rapid increase in the number of physicians was preceded by a sharp rise in their median income from a level less than seven times per capita income to a peak of 11.6 to 1 in 1962. As cost containment became more and more pressing, the rise in the number of physicians was accompanied by a decline in their relative income, even though their income continued to rise in absolute terms. By 1987, the ratio had declined from 11.6 to 9.1, and no doubt the decline is continuing.

Despite the sharp rise in the number and income of physicians, it is worth noting, first, that the cost of physicians' services accounts for only about one-fifth of total health care cost; and, second, that the share is less than it has historically been. In 1929, the cost of physicians' services was about 27 percent of total health cost, and after World War II, about 25 percent. The explanation is presumably a combination of more expensive equipment and greater administrative expense.

So much for input. What about output? That is the real problem. The output of the medical care industry that we are interested in is its contribution to better health. How can we measure "better health" in a reasonably objective way and in a way that is not greatly influenced by other factors? For example, if medical care enables people to live longer and healthier lives, we might expect that the fraction of persons aged 65 to 70 who continue to work would go up. In fact, of course, the fraction has gone down drastically -- thanks to higher incomes reinforced by financial incentives from social security. With the same "if," we might expect the fraction of the population classified as disabled to go down. That fraction has gone up, again, not for reasons of health but because of government social security programs. And so I have found with one initially plausible measure after another -- all of them are too contaminated by other factors to be regarded as reflecting the output of the medical care industry.

The least bad measure that I have been able to come up with is length of life. That too is seriously contaminated by other factors. Improvements in diet, housing, clothing and so on made possible by increasing affluence as well as such government measures as the provision of purer water, and better garbage collection and disposal have doubtless contributed to lengthening the average life span. Wars, epidemics, and natural and man-made disasters have played a part. Even more important, the quality of life is as important as the length of life. Perhaps someone more knowledgeable in this field than I can come up with a better measure of the relevant output of the medical care industry. I have not been able to.

Figures 6 and 7 present two different sets of data on length of life: Figure 6, on length of life at birth; Figure 7, on remaining length of life at age 65. The two tell rather different stories. For length of life at birth, data are readily available by sex and race, and I have concentrated on the length of life of females, and of white and black separately, in order to keep the populations involved as homogeneous as possible over a long period. Figure 6 shows the average length of life at birth of white and black females since 1900. As in the preceding chart, I have also included trends fitted to prewar data. The trends fit the data surprisingly well until the late 1950s.

Figure 6 -- Length of Life at Birth of Females, 1900-86, and Linear Trend for 1900-40

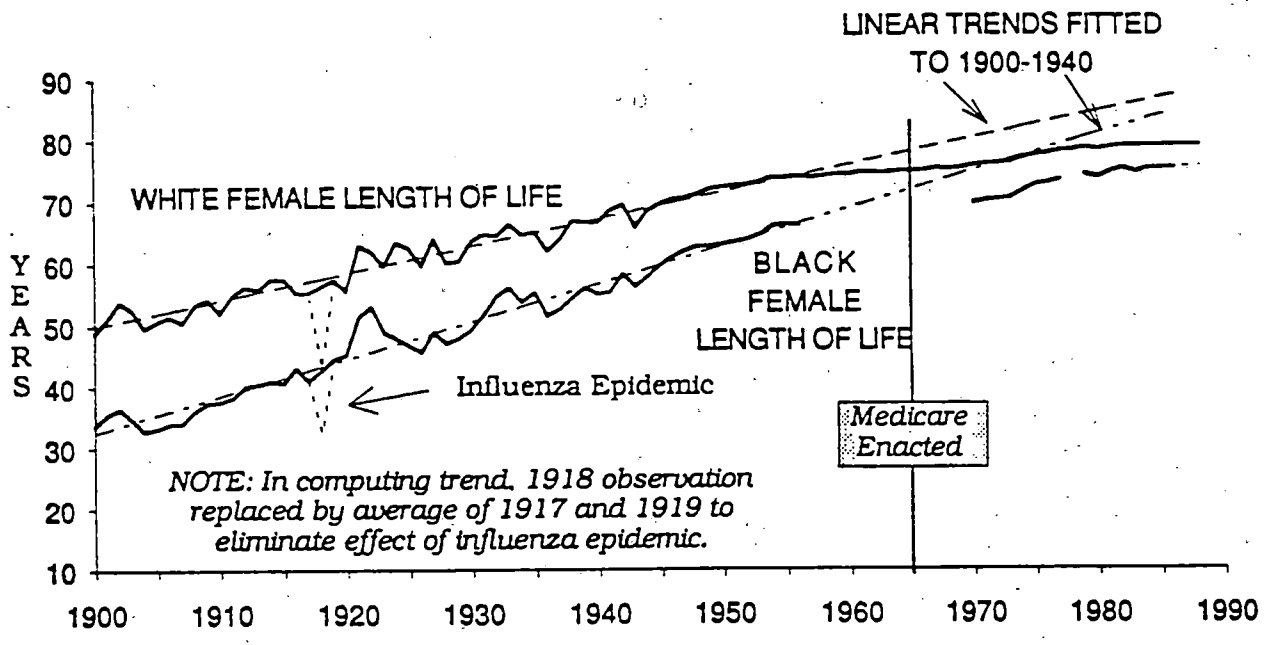
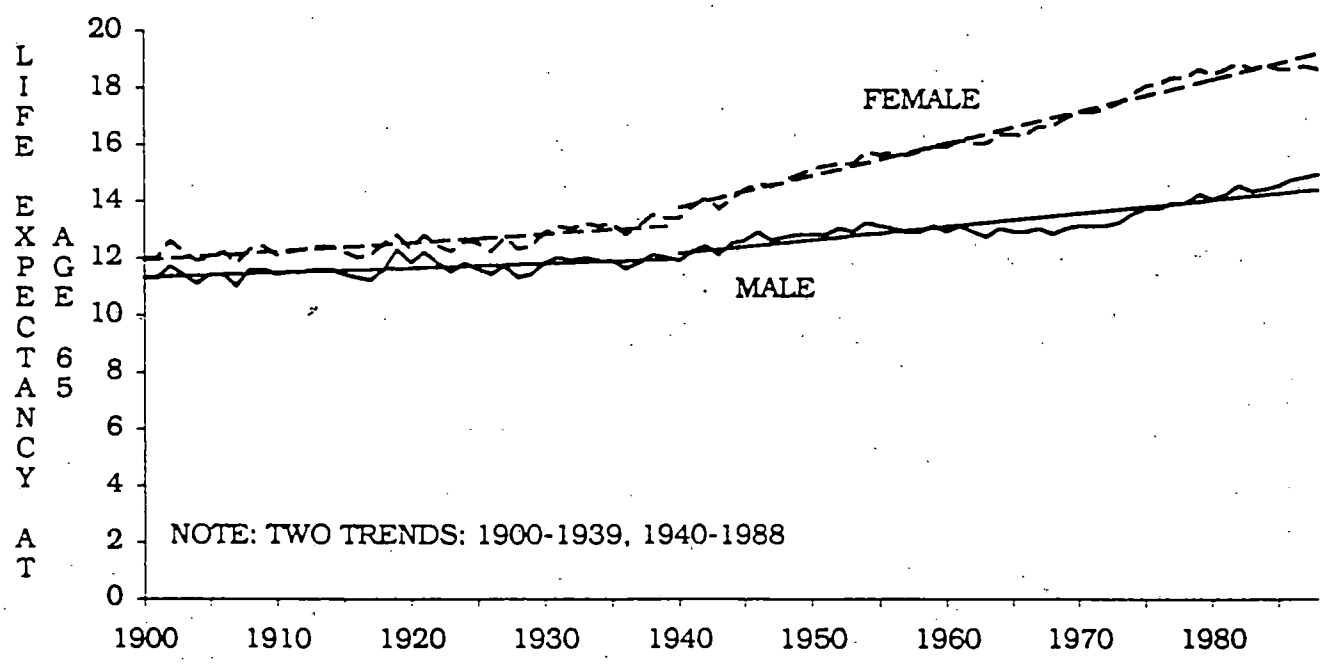


Figure 7 -- Male and Female Life Expectancy at Age 65: 1900-1988



Until then, life expectancy at birth of white females went up steadily from 48.7 year in 1900 to 74.2 years in 1959, and of black females from 33.5 to 65.2 years -- or, during the intervening 59 years on the average by 0.43 years per year for white females and 0.54 for black. The rise then slowed drastically. Life expectancy went from 74.2 and 65.2 in 1959 to 79.0 and 75.6 in 1989 for white and black females respectively -- or at the average of only 0.16 and 0.35 years per year during those 30 years. The rate of rise was more than halved for whites, cut by more than a third for blacks.

As the length of life increases, further increases are presumably more and more difficult to achieve -- early gains would seem to be the easiest. Yet Figure 6 shows no sign of any slowdown for the first 59 years of the twentieth century. The shift to a lower rate of improvement comes suddenly, not long before the rapid expansion in the Federal government's role in medical care and the sharp slowdown in the rate of increase in the amount of funds going to research.

Figure 7, on life expectancy at age 65, is for both races combined, since I have been unable to get data going far enough back for blacks and whites separately. In sharp contrast to Figure 6, it shows very slow though steady progress to about 1939, and then decidedly more rapid progress, especially for females. Does the speeding up around 1939 reflect the discovery about that time and subsequent wider use of a widespread range of antibiotics? I leave that as a puzzle for others. In terms of my own concern, the effect of greater government involvement, Figure 7 is of little help. For females, medicare is followed by an initial speeding up, then tapering off; for males, the pattern is almost the reverse: little or no change from 1950 to 1970, then a speeding up. In short, it will take a far more detailed and informed analysis to reach any clear conclusions about what has been happening to the output of the medical care industry, whether in terms of the length of life, and even more, the quality of life.

Nonetheless, for total medical care, as for hospitals, it is hard to avoid the conclusion that Gammon's law is at work. No question that medicine in all its aspects has become subject to an ever more complex bureaucratic structure. No question that input has exploded. No evidence that output has come anywhere close to keeping pace, though we lack a firm basis for going beyond this very general statement. "Black holes" indeed.

Why should we be surprised? Evidence covering a much broader range of activities documents that bureaucratic structures produce high cost, low quality, and inequitable distribution of output. That is the dramatic lesson taught recently by the collapse of socialism in the Soviet Union, China, and the Eastern European satellites of the Soviet Union. The U.S. medical system has become in large part a socialist enterprise. Why should we be any better at socialism than the Soviets? Or the East Germans? Or the Czechs? Or the Chinese? And on and on. Medicine is not unique. Our socialized postal system, our socialized schooling system, our socialized system of trying to control drugs, and indeed our socialized defense industry provide clear evidence that we are no better at socialism than countries that have gone all the way.

Yet not only do we keep on being surprised, but we continue in each of these areas to increase, not reduce, the scope of socialism. Nearly all the numerous suggestions for improving the glaring deficiencies in our medical system involve expanding the role of government, at the extreme moving from a partly socialist system to a completely socialist system!

3. Solution

I believe that the inefficiency, high cost, and inequitable character of our medical system can be fundamentally remedied in only one way: by moving in the other direction, toward reprivatizing medical care. I conjecture that almost all consumers of medical services, and many producers, would favor a simple reform that would privatize most medical care. Yet that reform is politically not feasible because it would be violently opposed by the bureaucracy that plans, controls, and administers the current structure of medical care.

The reform has two major steps: (1) end both medicare and medicaid and replace them by a requirement that every U.S. family unit have a major medical insurance policy with a high deductible, say \$20,000 a year or 30 percent of the unit's income during the prior two years, whichever is lower; (2) end the exemption from tax of employer-provided medical care; it should be regarded as a fully taxable fringe benefit to the employee -- deductible for the employer but taxable to the employee. Each of these reforms needs further discussion.

(1) Preferably, the major medical insurance policy should be paid for by the individual family unit, which should receive a reduction in taxes reflecting the reduction in cost to the government. There would be an exception for lower income families and for families who were unable to qualify for coverage at an affordable fee. The Government would help them finance the policy though not administer it. That would be done by private competitive insurance companies, chosen by each individual or family separately, who would, of course, be free to buy supplementary insurance if they so desired.

However, even if the government were to pay directly for major medical insurance for everyone -- rather than by reducing taxes -- there is little doubt that both government and total health cost would decline drastically because of the elimination of the tremendous governmental bureaucratic structure that has been built up to supervise a large fraction of all health activities.

(2) The tax exemption of employer-provided medical care has two different effects, both of which contribute to raising health costs. First, it leads the employee to rely on the employer rather than himself to finance and provide medical care. Yet the employee is likely to do a far better job of monitoring health care providers in his own interest than is the employer. Second, it

leads him to take a larger fraction of his total remuneration in the form of health care than he would if it had the same tax status as other expenditures. If the tax exemption were removed, employees could bargain with their employers for a higher take-home pay in lieu of health care, and provide for their own health care, either by dealing directly with health care providers or through purchasing health insurance.

These two reforms would completely solve the problem of the currently medically uninsured, eliminate most of the bureaucratic structure, free medical practitioners from the incredible burden of paperwork and regulation to which they are now subject, and lead many employers and employees to convert employer provided medical care into a higher cash wage. The taxpayer would save money, since total governmental costs would go down drastically. The family unit would be relieved of one of its major concerns -- the possibility of being impoverished by a major medical catastrophe -- and most could readily finance the remaining medical costs, which I conjecture would return to something like the 5 percent of total consumer spending that it was before the Federal government got into the act. Families would once again have an incentive to monitor the providers of medical care and to establish the kind of personal relations with them that once were customary. The demonstrated efficiency of private enterprise would have a chance to operate to improve the quality and lower the cost of medical care.

There is only one thing wrong with this dream. It would displace and displease the large number of people who are now engaged in administering, studying, and daily revising the present socialized system, including a large private sector component that has adjusted to the system. Most of them are highly competent at what they do, and would be able to use their abilities in productive activities if their current employment were terminated. But understandably, they will not see it that way, and they are sufficiently potent politically to kill any such reform before it could ever get a real following, just as the educational bureaucracy has repeatedly been successful in killing even modest programs for privatizing the educational system, even though poll after poll shows that the public supports privatization through parental choice.

Medical care provides a clear example of the basic difference between private and governmental enterprise. That difference is not in the quality of people who initiate or operate new ventures, or in the promise of the ventures. The people proposing and undertaking government ventures are generally as able, ingenious, and of as high moral character as the people undertaking private ventures, and the ventures they undertake may well be of equal promise. The difference is in the bottom line. If a private venture is unsuccessful, its backers must either shut it down or finance its losses out of their own pockets, so it will generally be terminated promptly. If a governmental venture is unsuccessful, its backers have a very different bottom line. Shutting it down is an admission of failure, something none of us is prepared to face if we can help it. Moreover, it is likely to mean the loss of a remunerative job for many of its backers and promoters. And they need not shut it down. Instead, in entire good faith, the backers can contend that the apparent lack of success is simply a result of not carrying the venture far enough. If they are persuasive enough, they can draw on the deep pockets of the taxpaying public, while

replenishing their own, to finance a continuation and expansion of the venture. Little wonder that unsuccessful government ventures are generally expanded rather than terminated. In my opinion, that is what is responsible for Gammon's "black holes," whether in medicine, schooling, the "war on drugs," agricultural subsidies, protectionism, and so on and on. That is the way high-minded motives and self-interest combine to produce what Richard Arney once labelled "the invisible foot of government." I challenge you to find more than a very exceptional counter-example.

I am indebted for helpful comments and assistance to Professor Gary S. Becker, Dr. Robert J. Cihak, Dr. James F. Fries, Dr. Thomas Moore, and, as always, to my assistant, Gloria Valentine, who did much of the detailed work of digging out the statistical data from a wide variety of sources.

Taxes / Incentive effects

RUSH!

The Executive Memorandum

The Heritage Foundation

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11/20/91 | Number 316

HOW THE KASTEN-WEBER TAX CUT WILL SPUR ECONOMIC GROWTH

The deep and painful recession afflicting America is the result of seriously flawed economic policies supported by George Bush and Congress. Record tax increases, costly new regulatory burdens, and unprecedented increases in federal spending all have combined to discourage job creation and entrepreneurship. Even though the evidence is clear that the economy remains stagnant, Bush Administration economic advisors actively are opposing growth legislation. And Bush apparently is following their bad advice. Warned *The Wall Street Journal* this week in an editorial: "Even as lusty a beast as the U.S. economy can take only so much punishment from its political masters in Washington. The long and short of it is: The world's most important economy is in the grip of economic incompetents." As long as it remains in their grip, American workers and families will remain condemned to lower living standards and rising unemployment.

Yet the economy can grow again if policy makers remove the shackles placed on it last year by the tax and spending increase. To do so, lawmakers must reverse course and correct the mistakes that are causing the recession and adopt policies that encourage job creation and increase incentives to work, save, and invest.

A good start is the Economic Growth and Family Tax Freedom Act of 1991 (S. 1920, H.R. 3744) introduced by Senator Robert Kasten of Wisconsin and Representative Vin Weber of Minnesota, both Republicans. The Kasten-Weber growth package cuts the tax on savings and investment, technically known as the "capital gains tax," lowers taxes on business investment, expands Individual Retirement Accounts (IRAs), offers real estate tax relief, and establishes enterprise zones. Kasten-Weber also relieves the tax burden on families by granting a \$1,000 non-refundable tax credit for children under age 6 and a similar credit of \$300 for children age 6 to 18. The credit significantly would reverse the rising tax burden on families caused by inflation's erosion of the dependent exemption over the past four decades.

With the economy mired in recession, the portion of the Kasten-Weber package designed to promote economic growth is particularly critical. Its key features:

15 Percent Capital Gains Tax—Germany, Hong Kong, the Republic of China on Taiwan, and South Korea do not tax long-term capital gains, the difference between an asset's purchase and sale price. In Japan, the maximum tax on capital gains is a mere 5 percent. In the United States, by contrast, capital gains are subject to a 28 percent tax. To make matters worse, the tax code ignores the fact that much of the higher sales prices and profits on savings and investments are due to inflation. American investors cannot use indexing to ensure that taxes only are paid on actual gains rather than changes in asset value caused by inflation.

The Kasten-Weber proposal would cut to 15 percent the capital gains tax for savers and investors in the upper tax brackets and to 7.5 percent for those in the lower bracket. To prevent the unfair taxing of gains that reflect only inflation, the legislation also permits indexing. By calling for a lower rate and including indexation, the Kasten-Weber capital gains proposal goes well beyond the anemic proposal endorsed by the White House and would provide a much stronger stimulus to the economy.

Note: Nothing written here is to be construed as necessarily reflecting the views of The Heritage Foundation or as an attempt to aid or hinder the passage of any bill before Congress.

Washington-based economists Gary Robbins and Aldona Robbins of Fiscal Associates, Inc., estimate that lowering the tax to 15 percent would create more than 900,000 new jobs over ten years and boost gross national product growth by an average of 0.36 percent for each year over the ten-year period. Other economists find similar impact from a capital gains tax cut. Allen Sinai, Chief Economist of The Boston Company, estimates that a 15 percent capital gains tax would boost employment by 600,000 within five years and increase the gross national product by 0.2 percent annually. Reducing the capital gains tax also would boost asset values, thus strengthening American banks and homeowners as well as reducing the cost of bailing out the federal government's savings and loan deposit insurance scheme.

Neutral Capital Cost Recovery—Kasten-Weber increases the amount of deductions businesses can take for investment expenses by adjusting "depreciation" schedules for inflation and the value of money. This reform substantially would boost capital formation by reducing the after-tax cost of investment. Under current tax law, businesses cannot deduct the cost of investments in the year when they are incurred. Instead, these costs must be "depreciated" over time, up to 31 years. Eventually, of course, the business is permitted to deduct the entire nominal amount invested. But the true value of this deduction is eroded enormously by inflation.

The Kasten-Weber neutral capital cost recovery approach would address the tax code's bias against business investment. If a business originally was supposed to depreciate \$10 million of an investment in the second year, for instance, Kasten-Weber might increase that depreciation to \$10.8 million, with similar adjustments in following years so that the value of the deduction would keep pace with inflation and the cost of funds. Correctly structured, neutral capital cost recovery would provide the same incentive for increased investment as plans permitting immediate deductibility of business investment in the first year. This would remove some of the current penalty on productive investment.

IRA-Plus—Kasten-Weber expands upon current IRAs by giving all taxpayers the option to invest in Individual Retirement Accounts. Savers, moreover, would get the option of investing in IRAs that would allow for tax-free withdrawal of both principal and interest income upon retirement. Taxpayers taking advantage of this "back-ended" IRA, however, would not be able to deduct contributions in the year they are made. In addition to allowing tax-free withdrawals upon retirement, Kasten-Weber would permit 25 percent of the IRA to be withdrawn before retirement for initial home purchases, education, and medical emergencies.

Passive Loss Reform—As part of the 1986 Tax Reform Act, so-called passive investors in real estate, those defined as not principally engaged in the business, cannot use rental properties losses to offset other income. Many experts say that this provision has helped trigger the decline in American real estate values and thus has increased the cost of the savings and loan deposit insurance bailout. Kasten-Weber would reform passive loss rules for real estate so they more closely resemble guidelines for other business investments.

Enterprise Zones—To encourage economic growth in impoverished urban centers and other particularly depressed sectors of the country, Kasten-Weber would allow the creation of 50 enterprise zones. Employers opening operations in the zone would receive a tax credit for workers in the zone. No taxes would be levied on capital gains in the zone, and investments in zones could be immediately deducted from taxes in the year they are incurred. These zones especially would help create jobs in inner cities.

Bush Administration and congressional policies have made it unprofitable for businesses to hire new workers and for investors to put their money at risk. Excessive taxation and overregulation have ground the economy to a halt and pushed nearly two million additional Americans into unemployment lines. Meanwhile, Washington policy makers seek not answers, but how to assign blame elsewhere. Bush clumsily blames credit card issuers for high interest rates, while liberals in Congress think higher taxes on the "rich" will spur growth.

There is no mystery about how to restore growth: simply reduce or remove government penalties on job creation, savings, and investment. The Kasten-Weber bill will not solve every economic problem created by policy mistakes, but enactment of the pro-growth legislation would stimulate increased economic activity and reduce the tax burden on families.

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THE HERITAGE LECTURES

Israel

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**Israel's Economic
Challenge:
How the U.S.
Can Help**

By Daniel Doron



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Israel's Economic Challenge: How the U.S. Can Help

By Daniel Doron

Especially now, when everyone's attention is riveted to the divisive issue of whether the United States should grant loan guarantees to the Israeli government, and if it does should it exploit its leverage to extract economic or political concessions from Israel, it may be useful to step back and consider these questions in a historical perspective. A proper understanding of the Israeli predicament—of how a nation so rich in human capital came to have such a lame economy—and of the steps that must be taken to help it overcome its difficulties may also have a significance transcending the particular case of Israel.

"Of all the lands there are for dismal scenery," Mark Twain wrote in 1867 in *The Innocents Abroad*, "I think Palestine must be the prince. The hills are barren...dull. . . . The valleys are unsightly deserts fringed with a feeble vegetation...[peopled by] swarms of beggars and peddlers [struck with] ghastly sores and malformations...., Palestine sits in sackcloth and ashes.... Only the music of angels...could charm its shrubs and flowers to life again. . . ."

It took, indeed, religious visionaries and, later—when the enlightenment secularized Europe's Jewish intelligentsia— utopian socialists to revive this "hopeless, dreary, heartbroken land." No *Homo Economicus* moved by rational expectations would have submitted himself to hunger, disease, pillage, and murder in lawless Ottoman Palestine in order to resuscitate its "waste of limitless desolation."

Thus I wrote in 1988, thoughtlessly repeating the prevailing myth that socialism played an essential role in the resettlement of what was then desolate Ottoman Palestine. The truth was that from the modern Jewish resettlement, Palestine in the mid-1800s, it was entrepreneurs, later aided by private charities, who established the first agricultural colonies and towns. They took enormous risks because they were moved by a deep religious faith that this was the way to redeem Israel from its atrocious exile.

Socialist Myth. After the turn of the century and until 1914, the Jewish population in Palestine doubled from 35,000 to 70,000. During that fourteen year period, private entrepreneurs established or extended in a most hostile environment three thriving towns, ten colonies, rudimentary industry and commerce, and an impressive educational and cultural network. It was during this same period that about 3,000 young, secular, penniless, socialist pioneers also arrived, five hundred of them to establish three collective settlements that were maintained by public support. Yet Zionist mythology credited the young socialist pioneers of the Second Aliyah with founding modern Israel. It obliterated all memory of the true founders, so much so that even though my great-grandfather was among the first settlers, and our family cherished the memory of his remarkable achievements, I, too, thoughtlessly accepted the myth about Israel's socialist origin.

This little episode is worth relating because the story of how socialism came to dominate the Zionist enterprise—reshaping its history, as well as eventually transforming the nature of the Jewish community in Palestine—contains a moral far transcending Israel's particular predicament. An Eastern European ethos has conditioned the development of modern Israel ever since

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the very inception of Zionism about 130 years ago, as I shall later explain. Therefore, the trials and tribulations of the Israeli economy, as it struggles to make the transition from a statist to a market economy, can shed significant light on the challenges and difficulties that Eastern European countries may encounter and can guide friends wishing to help.

I have advisedly chosen to dwell on what might seem as a tangential issue: the secondary role outside influences can play in an economic system's evolution. Many here may be involved in facilitating the transition in Eastern Europe. Israel's case demonstrates that the role of outside influences can sometimes be quite critical in shaping developments and alas, despite the best of intentions, not always in the most salutary manner. For sometimes help misapplied cannot only be counterproductive, but positively harmful and regressive.

Well-Intentioned Friends. To return, then, Zionism certainly has a predisposition to contract socialism fever. Historical circumstances, especially the long entrenched autocratic abusive regimes that were legitimized by orthodox Christianity, made all of Eastern Europe, particularly the Jews, vulnerable to revolutionary fervor and utopian temptations. However, this disposition could not have successfully taken over Zionism if not for the well-intentioned intervention of friends, most from the West, many from America, who participated in events in Palestine without much foresight or care.

When in 1920, under the British Mandate, Palestine's doors opened, tens of thousands of displaced European Jews clamored to emigrate. A totally unprepared Zionist organization stopped them, ostensibly for economic reasons, but really because its purpose was to shape the development of Palestine's Jewish community in a certain direction.

Eastern European Zionist leaders such as Chaim Weizman accepted the anti-Semitic calumny that Jewish society was at least partially responsible for its misery because Jews were not a productive, land-tilling people, but parasitic capitalists. They therefore wanted to create a new Jewish person and society, based on "honest" labor, and not the traditional middle class society of entrepreneurs.

Conversely, Judge Louis Brandeis and his followers in American Zionism were convinced that only the encouragement of private enterprise could provide a sound economic basis, and that a collectivist system would pose a danger to democratic society. But they remained a minority. The Utopian collectivist ideology prevailed; Brandeis resigned from the Zionist Organization of America, and Weizman and his supporters were able to channel all Zionism's resources into the collectivist sector, thus turning it from a tiny minority to the dominant economic and political force in Zionism.

Inhibiting Entrepreneurship. The Zionist settlement department and its considerable resources were devoted to the promotion of a socialist-dominated society, while great handicaps were devised to inhibit the growth of middle class entrepreneurship. This occurred despite repeated failures of the collectivist sector, which survived only through constant infusions of public money. Public money was raised, ironically, mostly from middle class American Jews who sincerely wanted to help, but could not really bother to learn the issues facing Zionism or to act carefully to prevent their help from tilting the balance in favor of socialism.

As it has had elsewhere, socialism has had a devastating effect on Israel. In the thirty years preceding the State's establishment, and in the forty years following it, Israel created, with the benefit of huge capital inflow (over \$70 billion since the State's creation), with back-breaking work and with sometimes superhuman sacrifice, a laggard economy incapable of offering the Israeli worker more than a measly \$1,000 monthly average salary. Instead of permitting the Jewish people to invest their considerable talents and resources in creating an urbanized, highly-industrialized center with advanced service industries and a sophisticated financial industry

capable of absorbing millions of highly-educated Jews, Zionism established, before independence, only a small community based on a weak, agrarian economy. After independence, it spawned a centrally-dominated and collectivist economy, which made Israel economically dependent on foreign help.

Zionism's inhibitions on urbanization and industrialization, which could have assured a high standard of living to all the inhabitants of the land, had serious repercussions. The backward collectivist economy, with its essentially discriminating political manipulation, sharply increased social and ethnic divisions. Incessant struggles over the division of the pie corrupted politics and degenerated economics. It also gravely damaged productivity by the wholesale misallocation of resources and by channelling so much energy into the seeking of privileges.

The economy's politicization also aggravated the Arab-Israeli conflict. Concentrating the Zionist effort on agriculture inhibited economic growth and naturally intensified the confrontation with the Arabs, who were mostly rural. It focused the struggle on land and water, which are limited resources that are difficult to share. And slow economic growth and sluggish demand for labor also sparked a struggle over employment in Mandatory Palestine.

Economic Discrimination. Later, in independent Israel, when much of the economy belonged to national or public entities, with economic benefits a political coin, the Arab population, lacking political clout, was subject to the economic discrimination inherent in excessive politicization, much in the same way and for the same reasons that the Sephardim were discriminated against. To this day, lack of opportunity and economic discrimination strain the fealty of Israeli Arabs.

By the time of the creation of the State, socialism was, of course, well entrenched, but its repeated economic failures forced Labor governments slowly and painfully to reduce their total control of the economy, though not nearly speedily enough. In the late 1970s, growing discontent with the malfunctioning of the Israeli economy was a major factor in Labor's loss. A reformist party siphoned off enough Labor votes to gain sixteen Knesset seats, thus enabling Likud to become the majority party and form a government for the first time.

Ostensibly pro-private enterprise, Likud made a hasty, ill prepared and tentative attempt to reform the economy. It was so ill conceived and executed that it caused skyrocketing inflation. Also, soon enough the allure of power and the strength of populist elements in the party led it to greatly increase the government's involvement in the economy. It had far more involvement than labor, by exploiting increased foreign aid to greatly extend social benefits, the welfare system, and huge subsidies to industry and the consumer. Even today, when economic aid mostly covers the repayment of debt and is therefore merely a bookkeeping exercise, it still enables the government to delay vital structural change.

Tangle of Regulations. Under Likud, then, government intervention in the economy reached new heights. The government owns over 200 corporations in all economic spheres. Despite some very halting steps toward privatization, it still controls the import of many staples. It sanctions dozens of monopolies. The government has recently moved to lift many import regulations, but in too many cases, it has simply switched from bureaucratic restrictions to high duties to protect inefficient Israeli industries from competition. One can scarcely engage in any profession or trade without a government permit or compliance with a tangle of regulations, an especially serious impediment to the Russians wishing to enter the economy.

Government denies free or easy entry to the market and ties the hands of producers with onerous labor laws. It imposes on labor and employers punitive taxes that destroy their competitiveness and nip in the bud new enterprises. As a result, Israel has a very small proportion of small businesses, which in turn curtails competitiveness and efficiency. Israel has over two

dozen different major taxes and dozens of special levies (imposed, for example, on stud rams, camel markers, and reburials). As much as 55 percent of gross national product is taken in taxes, although about 25 percent is returned in subsidies and transfer payments.

Discredited Statism. Yet despite the fact that Israel has perhaps earned its bad annual report cards, there are tremendous changes afoot there. In the past few years, statist ideology has been almost totally discredited in Israel. Ironically, even when the government attempts to intervene in a massive way, as in a recent plan to promote employment by granting generous subsidies to industry, it does so putatively to "assist the workings of the market" and to "encourage enterprise." But such excuses do not usually wash, and most of the press and many in the policy community are quick to expose the absurdity of such government assistance. This is light years away from what prevailed even as recently as six or seven years ago, when government proposals were often criticized, but only on the grounds of their ineffective execution, while their necessity or *raison d'etre* was seldom questioned. As a result, a number of major economic initiatives the government planned, that would have cost Israel billions of dollars, have been squashed.

Even though it seems that the political establishment is reluctant to accelerate change, it apparently understands where the wind blows. In September, we witnessed an astounding phenomenon: a Labor party that still finds it difficult to separate itself from its red flag and May Day celebration, launched a massive ad campaign attacking the Likud government for not being friendly enough to free enterprise. A new Labor election platform calls for privatization and reduced government interference in the economy.

The refutation of statist ideology has also brought about other changes in policy. While only a few major reforms have been successfully completed so far, those familiar with political undercurrents can discern significant beginnings for profound future changes.

There were two developments within the Israeli economic and political system that caused many of these changes and that are worth commenting upon because they may contain significant lessons about how the internal dynamics of a statist economy eventually mandates transition to a market economy.

If we were to analyze Israeli politics strictly by the hypotheses of social choice theory, there could be very little prospect for economic reform. Since Israeli politicians are in almost total control of the economy, only revolutionary change could force them to forego their enormous power. Yet it seems that the extensive use of economic favors to buy political influence finally makes the political exploitation of the economy self-defeating.

Vested Interests. One can observe an interesting favor-seeking process on the national scene, even, most significantly, within political parties. Having offered so many government favors to their followers, Israeli political parties have in effect, been transformed into unstable coalitions of vested interests vying for government favor. Since even the Israeli government does not possess unlimited resources, party lords cannot ultimately satisfy the needs of all their constituencies, whose expectations keep rising much faster than favors can be granted.

Moreover, even if an attempt was made to satisfy them all equally, it would not prevent a destabilizing struggle from developing, for each group would consider itself more deserving and would demand more favors, not least as a token of its larger political clout. Thus, for every satisfied customer that a leader acquires by dispensing political favors, he creates a number of dissatisfied clients, and several political enemies. Parties then resemble families torn by conflict and intrigues as a result of a sudden inheritance that must be shared. With no objective economic criteria to indicate how such a windfall can be divided and no productive effort to be rewarded,

personal and political ambition become the predominant factors and rivalries and jealousies abound. Finally, they destabilize and break apart the family or the party.

It seems then that while the setting of a constitutional limit on the economic power invested in government and in political parties may be necessary, what will make such a limit acceptable and even desirable to politicians is the realization that the dispensing of political favor is eventually counterproductive. Politicians must recognize that rather than securing their hold on power, in the long run it undermines it. They also must realize that since a nation's strength depends on its economic viability, its political system cannot long survive massive government control of the economy, as we have witnessed in Eastern Europe and even in Sweden.

A second process that holds great promise for spontaneous grass roots and market-generated reform can be witnessed in Israel in the way market forces eroded the political establishment's economic base while empowering previously disenfranchised citizens. Decades of political manipulation and misallocation of resources have finally taken their toll on industrial enterprises owned by government, the Labor Party and the banks, as well as the Labor-affiliated sick fund, pension funds, and agricultural cooperatives. Moreover, the same relentless forces that are finally weakening Israel's statist economy are also beginning to reward, albeit, haphazardly, Sephardic Jews who lacked access to the system and therefore had to make it independently, mostly in the informal economy.

Healthy Attitude. A survey of income disparities in Israel between Ashkenazim (Jews of European background) and Sephardim (Jews from Arab countries) discovered that despite extremely high taxes and transfer payments, income gaps kept growing among these groups in the public sector. But among independent wage earners, Sephardim moved up faster and overtook the Ashkenazim. Ashkenazim, mostly well established officials, discovered to their chagrin that while education and contacts gave them access to coveted jobs, they remained highly taxed. The more recently arrived Sephardim, lacking such connections, moved into trades and small businesses where they satisfied rapidly expanding demands and participated in the underground economy. Never having been infected by the ethos of socialism, they were generously rewarded for their healthier attitude toward enterprise.

Many Sephardim rose in the Israeli political hierarchy through the direct elections of mayors, making them more responsive to public needs and accountable to their constituencies than Members of Knesset who are put on the slate by the executive committee.

However, what might really force the hand of the system and promote change is the massive wave of new immigrants from the Soviet Union. The challenge of housing and providing jobs for tens of thousands of new immigrants can simply not be met by Israel's sluggish economic system. As a matter of fact, already the government has had to forego its intervention in the initial absorption process and allow for direct absorption by handing each immigrant family a subvention with which to purchase housing, food, clothing, and education. As a result, Israel was able to absorb the first wave of almost 300,000 immigrants without initially having to add to the existing housing stock. Suddenly, tens of thousands of empty apartments, which were owned as inflation-proof investments, were put on the rental market, and provided the necessary housing.

In the area of employment, too, markets have operated much more gingerly than statistics reveal. Official figures show an 11 percent unemployment rate in Israel. Yet it is difficult to secure the services of a maid for even \$10 an hour (the average monthly salary in Israel is \$1,000), and there are many thousands of illegal foreign workers from Poland, Portugal, Ghana, Turkey, Romania, and the Philippines (besides the scores of thousands of Arab workers from the West Bank, Gaza and even southern Lebanon) who find employment in Israel. This apparent paradox of jobs going begging while there is apparently such a high rate of unemployment is due

not only to the disincentives provided by high unemployment compensation on the one hand, and significant taxes imposed on low income brackets on the other, but also because much employment is in the informal sector.

Altogether, the existence of a vigorous informal sector, while saving Israel from being torn apart by disruptive social tensions and economic hardships, has also reduced the pressures for reform, especially of the tax system. People often wonder why Israelis, who are among the highest taxed people in the world, have not declared a tax revolt. The reason seems to be that they have "privatized" their revolt, sometimes by individual tax evasion, but more often by sectorial arrangements whereby although the taxable portion of the salary is small, the worker receives various perks, on which often only the employer pays taxes. The unfortunate result is that while take home pay is very low, the cost of labor to the employer is very high.

Once hidden excess capacities in the job and housing markets are exhausted, however, the need to create additional jobs and additional housing for the immigrants will come up against the rigidities inherent in Israel's statist economy.

The greatest hope for rapid employment expansion is small businesses. Their proportion in Israel is much smaller than that prevalent in Western economies, because the Israeli economy is rife with government-sanctioned monopolies, with government bias in favor of large enterprises, with onerous entry limitations (one, for example, cannot establish a pharmacy within a radius of 500 meters from an existing one), and heavy taxation at low brackets preventing capital accumulation. If Israel is rapidly to expand employment, massive deregulation and lower taxation must be instituted.

In housing, too, government interference is the major hindrance to rapid expansion. We have calculated that the average three-room apartment in Israel that now costs \$100,000 contains at least \$65,000 in government-imposed costs: inflated land prices (the government owns 93 percent of the land), capital consuming lengthy planning and regulatory procedures, high taxes on building materials and labor, government-sanctioned monopolies in steel, iron, cement and in contracting services.

A Blueprint for Reform. So what can be done besides complaining and issuing bad report cards? In February 1990, my organization, the Israel Center for Social and Economic Progress, held an international conference with the participation of over 2,000 people (including Israel's President, ministers, Knesset members and other pillars of the establishment, and foreign dignitaries, such as Milton Friedman, Justice Antonin Scalia, Trevor DeCleans, Stuart Eizenstat, and others). With their help we were able to produce a blueprint for reform.

- ◆ The government budget and taxes must be cut drastically. We put together a detailed plan that pointed out chapter and verse how to cut 10 percent of the budget simply by eliminating duplication and waste.
- ◆ Tax systems and capital markets must be reformed and hidden capital legitimized so a thriving underground economy can be integrated into the formal one, and thus increasing productivity.
- ◆ Government companies, including those in the defense industry, must be sold, but not through a lengthy piecemeal process that encourages powerful interests to acquire them at preferential terms. They must be incorporated into two or more competing mutual funds whose shares should be offered to the public.
- ◆ Government must release vast tracts of land and sell them to the highest bidder.

- ◆ A pending law to encourage rental housing must be finally enacted. This will help make the building industry more efficient and competitive.
- ◆ Once competitiveness and efficiency have been accelerated, municipalities can privatize their services, and so save a large portion of their outlays. This will enable them to reduce local taxes, which are a heavy burden, especially on small businesses.
- ◆ Above all, the Israeli economy must be massively deregulated to become truly competitive. A blue ribbon committee should be established to review all government regulation of economic activity. Those that are not proven cost effective or that impede economic growth should be abolished within a reasonable period of time.

Now that our seven years of work have conspired with circumstances to convince most Israeli decision makers and public opinion molders that economic reform is a top priority, and that only a market economy can assure Israel's viability and security, the hard work has only begun on how to get from here to there. As experts in Eastern Europe point out, it is not enough to convince people that reform is necessary; it is not even enough for them to want it desperately. They still have to develop concrete strategies, adapted to an economy's particular circumstances, to its unique institutional setting and its social relationship, if they wish to see reform not only enunciated but actually carried out.

You have to identify the groups that would cooperate on economic reform and try to win over those resisting it in order to both generate support and eliminate or modify opposition. This requires more than annual rhetorical exhortations telling the government to shape up and do certain things or to refrain from doing others. It takes a much more arduous effort to persuade decision makers that reform is in their best interest in the long run, to teach them the ABC's and the syntax of proper economics so that they can all write a better economic scenario in their own spheres of action. Holding out a foreign model for reformers and expecting them to follow it on faith will just not do the trick.

The setting up of foreign models to be emulated may prove to be counterproductive unless done with the utmost sensitivity and discretion. The particular ethos of different countries, their unique aspirations, institutional dynamics, and even their peculiar semantics may be so different, that those opposing reform could easily seize on such differences in order to discredit the notion of reform.

Judicious Criticism. To those who exhort Israel to follow the example of Hong Kong or South Korea, many Israelis would retort that since these are not democratic countries, they can resist the pressure to close great discrepancies in wealth. Also since, at least until recently, large parts of their populations were not well educated, they could not serve as models to a country like Israel wishing to integrate a great mass of very educated immigrants who thought that if the price for democracy and greater equality must be greater government involvement in the economy, so be it.

It should also be remembered that strident, often simplistic, even slanted, foreign criticism of Israel, and attempts by outsiders to twist the arm of its government, even if well motivated, may alienate many Israelis. For they already feel that they are exposed to far too much foreign scrutiny and double-standard criticism. This criticism may play into the hands of those who resist reform by enabling them to recruit patriotic feelings.

So, to be effective, foreign critics must act very judiciously and sensitively and not indulge in generalities and in intemperate rhetoric. They must remember what a daunting task basic economic reform is even in countries which enjoy relatively free market economies and not expect that by acting as visiting firemen they can institute reforms in foreign economies overnight.

This is not to say that foreign friends should keep away and not lend a helping hand. To the contrary, they have a vital role to fulfill in encouraging local advocates of reform. Since official U.S. representatives tend to confine their contacts and attention to official circles and the establishment that is associated with them in statist economies, the population gains the impression that U.S. sympathy and prestige are behind the policies they follow.

It is therefore vital that voluntary U.S. organizations find a way to convey to the people in these countries what the U.S. really stands for in terms of the values and policies associated with the market economy, by establishing their own ties with their counterparts in these countries. Where such counterparts are lacking, as in many autocratic regimes in Latin America, the Arab countries, and the Far East, they might want to emulate the example set by the Open Society Fund which successfully sowed the seeds of a civil society in many East European countries when they were still communist.

Local reformers should be helped by permitting them easier access to the experience accumulated by reformers elsewhere, and the means should be provided to help transmit such knowledge in their native language and in terms assimilable by their own culture. Often it is most difficult for such reformers to raise funds for their activities in their own countries since the source of most wealth is in the government's hands and with those who benefit from government intervention and would therefore oppose reform.

Rethinking Foreign Aid. Above all, the time has come for proponents of economic reform to give some very serious and urgent thought to how to neutralize some of the very destructive consequences of government-to-government foreign aid that in the past often resulted in creating in the beneficiary countries an overbearing and injurious public sector. Can government aid be used as a leverage to encourage the private sector of developing countries, and if so, how?

It is clear that most countries wishing to make the transition from a statist to a market economy are facing formidable problems. They urgently need help. But, as the saying goes, it is better to teach them how to fish than to provide them with fish.

Educating people to function in a market economy is a long, arduous process, but there are no short cuts. It is the reformer's task not to hit their opponents over their heads, but to educate them patiently, convince them that through individual freedom and free markets their yearning for a better life can be realized sooner, more peacefully, and even more justly.



Economy



Watch

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November 1991

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| | Rest of 1991 | 1992 | Comment |
|-----------------------|--|---------------------------------------|--|
| Growth | 4th-Q real GNP growth about 3%. | Growth slows to 2% at mid-year. | 4% + growth in 1993's 1st half. |
| Inflation | CPI 3.0% yr/yr avg., 3.5% annualized. | 3.0% yr/yr avg., 3.1% annualized. | Inflation jumps to 4%-5% peak in 1993. |
| Interest Rates | 30-yr. T-Bond yield just below 8%. | Yield bottoms around 7-1/4%. | Yield hits 8-1/4% in mid-1993. |
| Stocks | Stocks move generally higher. | Rally continues: DJI hits 3,300. | DJI peaks at 3,800 at end of 1992. |
| Dollar | Dollar rises v. DM, eases against yen. | Dollar peaks near DM1.90 in 1st half. | Germany struggles with inflation awhile. |

After the Fall: Dow at 3,800

Bull markets climb a wall of worry, says the old adage. The recent 5%+ correction in the Dow Jones Industrials has raised widespread fears that a bear market is beginning. We don't think so. Like the consensus, we've trimmed our forecast for current-quarter GNP (though not for industrial output), but continue to think that we'll soon see

positive surprises, for example in industrial production. Meanwhile, a further improvement in the outlook for inflation reinforces our view of a bond rally in 1992. Moderate growth plus a bond rally add up to a strong advance in the stock market. We're raising our target for the Dow Jones Industrials a year from now to 3,800.

Growth. This is a moment of truth for our growth forecast. After sharp gains in April through July, industrial output paused for three months (see graph). If we were right last month in calling this "a blip down on the way up," industrial growth should resume in November, and continue until about February (Section 2.5). So far, our forecast of industrial output has been on the button; but real GNP growth has been weaker than we forecast. We're scaling down our forecast for the current quarter, but still expect GNP to surprise the consensus at 2.9% in the fourth quarter, a bit faster than the third (Section 2.6).

Inflation. In May we argued that year-to-year producer price inflation, then 3.2%, "could fall almost to zero in the fourth quarter." In July we said CPI inflation would fall to a low of 3%. CPI inflation hit 2.9% and PPI inflation 0.0% in October. We expect year-to-year inflation to stay near these levels until the latter half of next year. CPI inflation

should rise to a 4-5% peak in 1993 (Sections 1.4 & 1.5).

Bonds. We expect the 30-year Treasury bond yield to tarry near 8% as stronger-than-expected growth is digested. But bonds should rally on low inflation news

until the yield reaches 7-1/4% toward the end of 1992. We continue to expect the jump in inflation in 1993 to drive yields up 100 basis points (Sections 3.1 & 3.2).

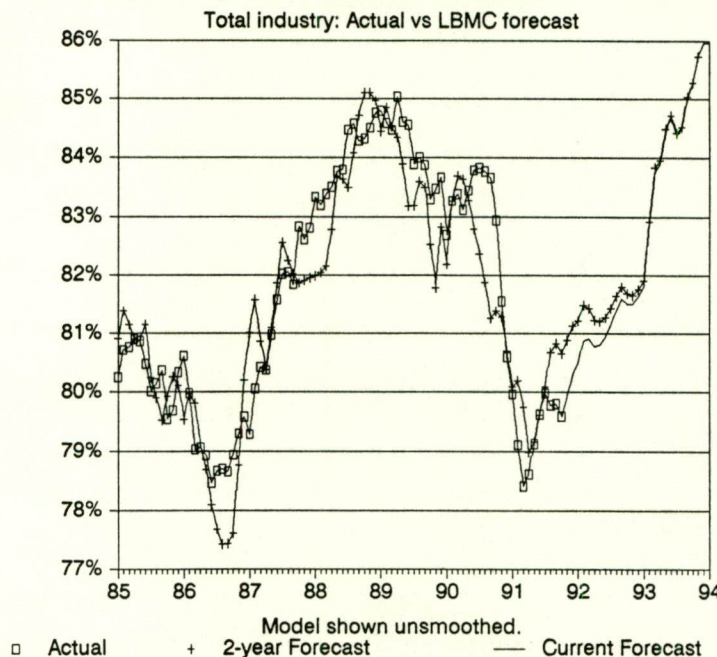
Stocks. We think the November stock market correction will be followed by a rally. In fact, we've raised

our estimated peak on the Dow to 3,800 by the end of 1992 (Sections 3.3 and 3.4).

Dollar. We were right in thinking that the dollar would continue to weaken against the yen. But in November the market strongly disagreed with our view that the greenback would rise against the Deutschmark. Undaunted, we expect the dollar to rise and the DM to fall from here (Section 3.5).

Moment of Truth.

Capacity Utilization: 2 Years Ahead



1.0. The Outlook for Inflation

1.1. LBMC's World Dollar Base

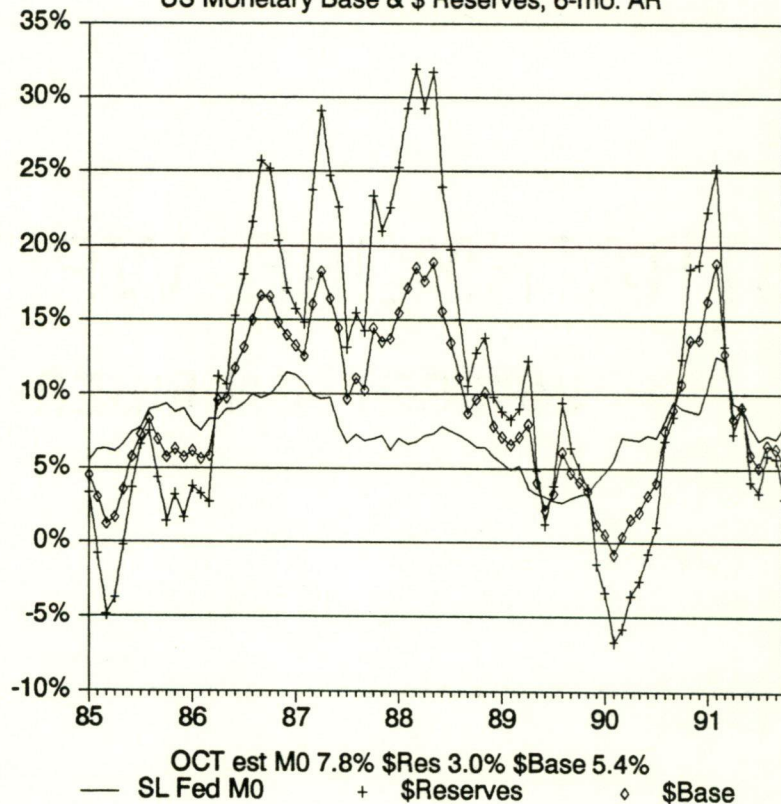
Explanation. The world's central banks and basic commodity markets operate on a "dollar standard." So Lehrman Bell Mueller Cannon, Inc. uses what we call the "World Dollar Base" as a key forecasting tool. In principle, the World Dollar Base comprises the U.S. monetary base ("high-powered money") plus the dollar reserves held by foreign central banks to back their domestic currencies. When the World Dollar Base grows, it adds to liquidity in the dollar market. The first effect is on financial markets, then output; in the longer run, prices (especially raw materials, food and energy prices).

Latest. Despite a slight reacceleration of U.S. domestic monetary growth, the 6-month growth rate of the World Dollar Base ticked down to just over 5% in October. However, in November foreign dollar reserves rose sharply in response to the dollar's decline, and we expect growth

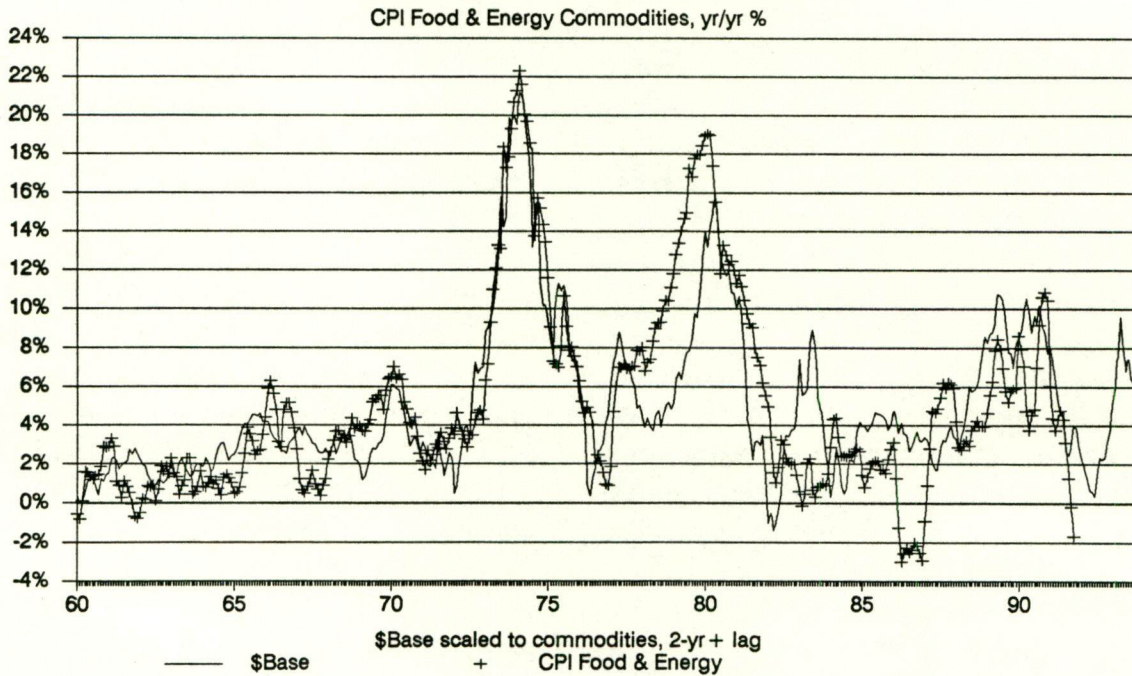
of the World Dollar Base to quicken a bit in coming months (though probably not into double digits). The implications? Despite a sharp slowing in its growth, dollar liquidity remains positive even after adjustment for inflation and should not pose a threat to the economic recovery (see Section 2.1). Also, it looks as though the extended commodity-price disinflation should be interrupted starting in 1992's second half with a single sharp burst of inflation, lasting until mid-1993 (see next page).

LBMC's World Dollar Base

US Monetary Base & \$ Reserves, 6-mo. AR



LBMC's World Dollar Base & Commodities



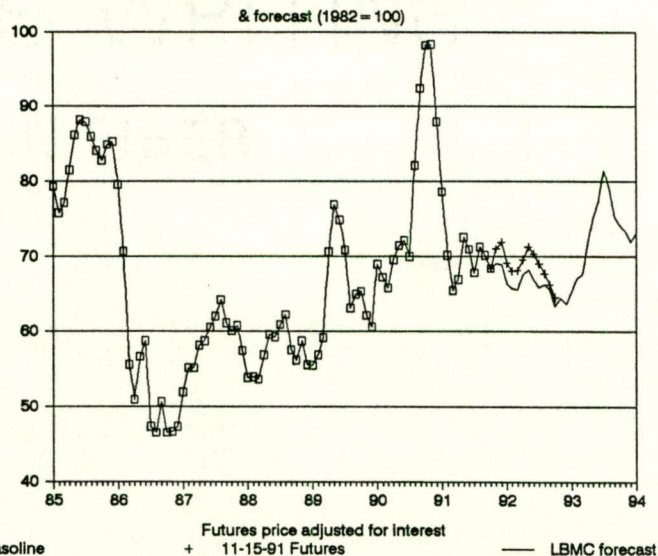
1.2. Commodity Prices

Explanation. The World Dollar Base is useful in predicting overall commodity inflation two years in advance. Of course, specific commodity prices also reflect relative scarcity. For example, due to its importance and semi-cartelized market, energy supply must be analyzed separately. We use the price of gasoline as a benchmark.

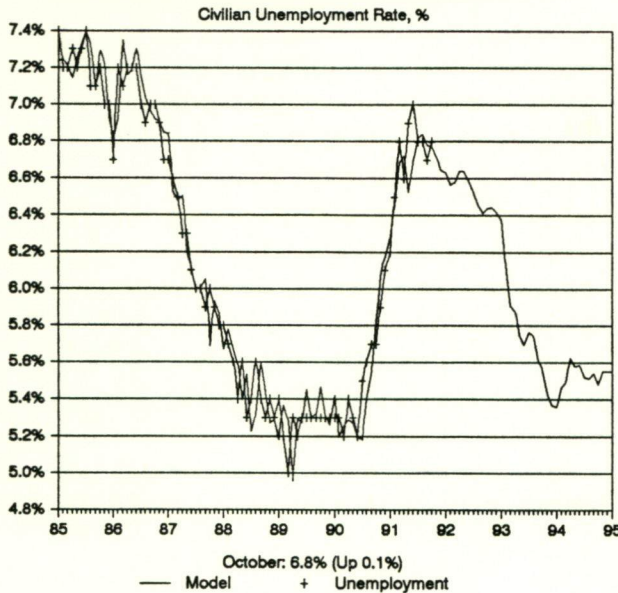
Latest. Commodity disinflation continues, thanks in large part to the monetary tightening that also triggered the recent recession (graph above). The energy futures markets remain in fairly

close agreement with one incorporating the World Dollar Base until the end of next year (see graph below). We expect a spike in food prices in late 1992 and energy prices in the first half of 1993.

Gasoline: Producer Price



LBMC's Unemployment Model



1.4. LBMC's PPI Model

Explanation. LBMC's PPI Model forecasts producer price inflation for finished goods. The model is based on separate forecasts of PPI sub-indexes for food, energy, and other goods.

Latest. Producer prices rose 0.8% in October (0.7% after seasonal adjustment). Yet year-to-year PPI inflation fell to 0.0%, fulfilling our forecast this year of PPI inflation falling to zero. Much of October's rise was concentrated in the ex-food-and-energy category, but seems to be a fluke which should be followed by an abnormally low rise this month. We see

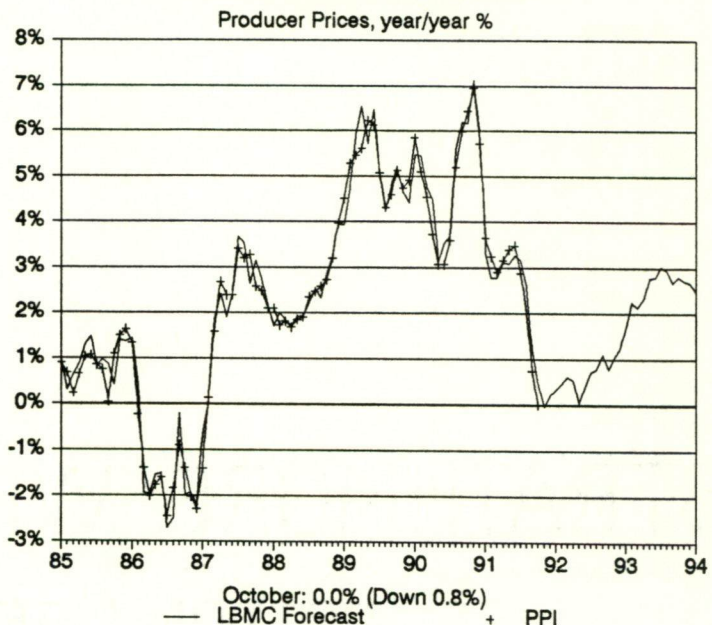
1.3. Labor Costs

Explanation. Labor-intensive goods are not priced like commodities. So LBMC's inflation models contain a monthly proxy for wage costs.

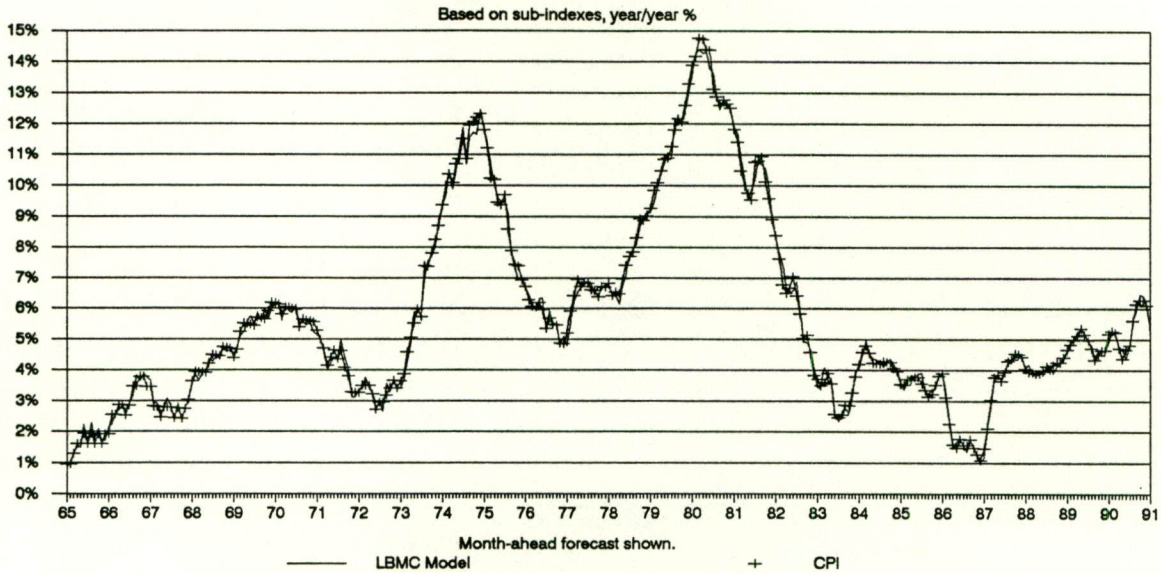
Latest. Our forecast for unemployment, which figures in our forecast of labor costs, is a few tenths higher than before. This may not sound like much, but cumulatively helps lower our forecast of CPI inflation by about three-quarters of a percent for 1993.

year-to-year PPI inflation remaining in the 0-1% range for the next year, then jumping 3 percentage points in 1993, due to commodity inflation and rising labor costs at that time.

LBMC's PPI Forecast



LBMC's CPI Model



1.5. LBMC's CPI Model

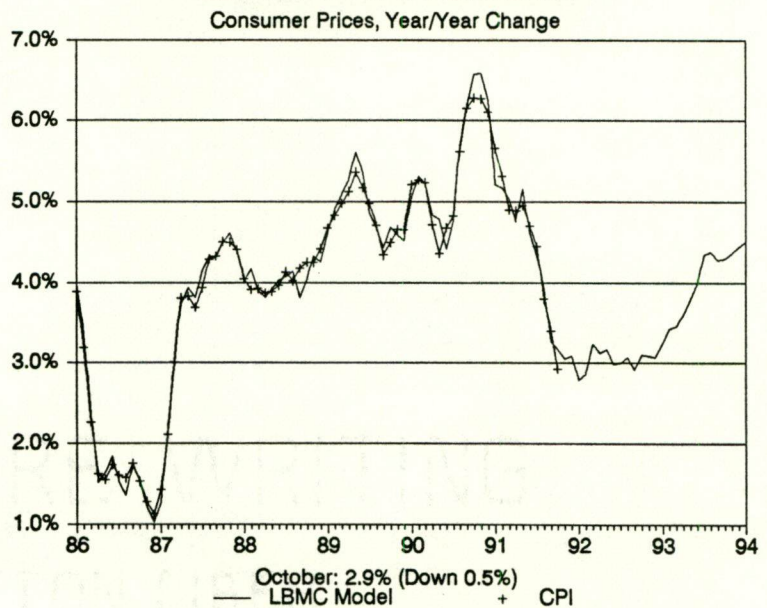
Explanation. Like our PPI Model, LBMC's CPI Model is based on separate explicit forecasts for the food, energy, and ex-food-and-energy sub-indexes.

Latest. The CPI rose 0.1% in September (also 0.1% after seasonal adjustment). Our estimate last month was 0.2% seasonally adjusted. This cut year-on-year inflation to 2.9%.

The overall number was helped by a drop in so-called "core inflation" to 0.1%, but we expect this to bounce up in November, resulting in an overall

seasonally adjusted CPI rise of 0.3%. We expect year-to-year CPI inflation to stay around 3% until late next year. CPI inflation should average 4.3% year-to-year in 1991 and 3.0% in 1992. But we expect the CPI to rise to a peak of about 4-1/2% year-to-year in 1993.

LBMC's CPI Forecast



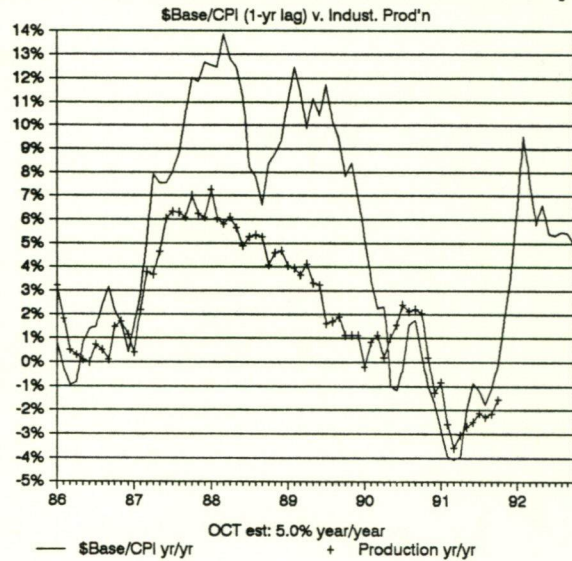
2.0 The Outlook for Growth

2.1 "Real" World Dollar Base

Explanation. The *level* of output is mostly determined by supply factors; but business-cycle *fluctuations* are partly related to "excess" money -- money not demanded to exchange wealth at existing prices (see "The Rueffian Synthesis" and "The World Dollar Base and Business-Cycle Forecasting," June/July & September 1991 **LBMC Reports**). A good measure of "excess" money is Treasury debt monetized by the banking system (graph below). In recent years, increases in the World Dollar Base have formed the bulk of such monetization.

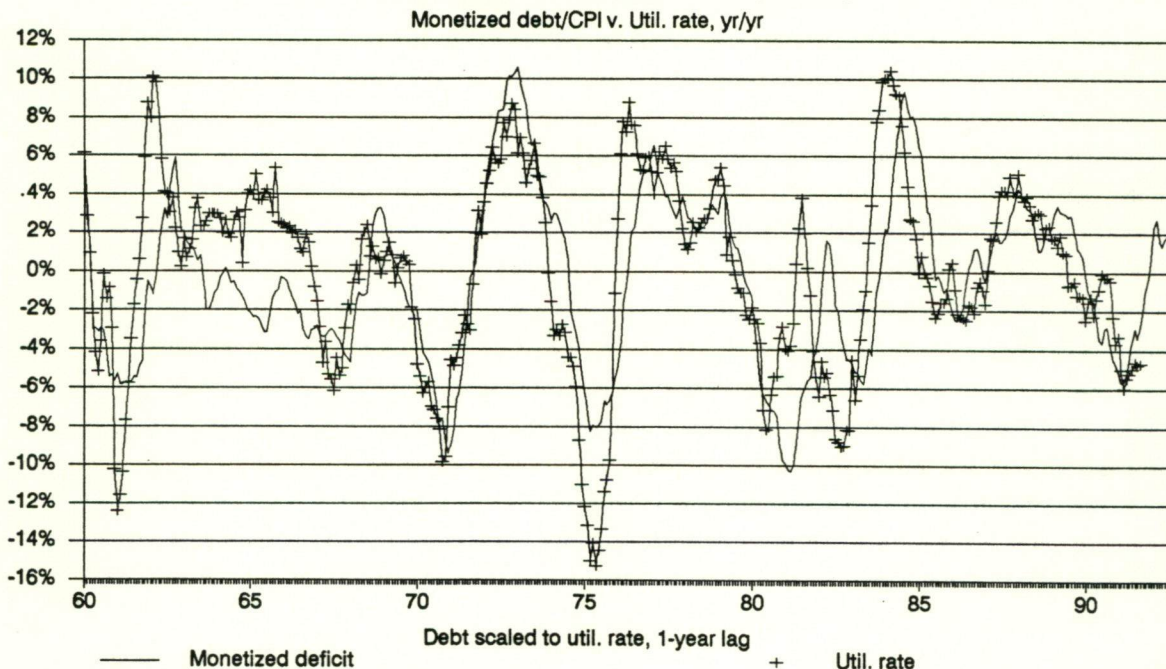
Latest. After inflation, LBMC's World Dollar Base grew 5.0% year-to-year in

LBMC's World Dollar Base & Output



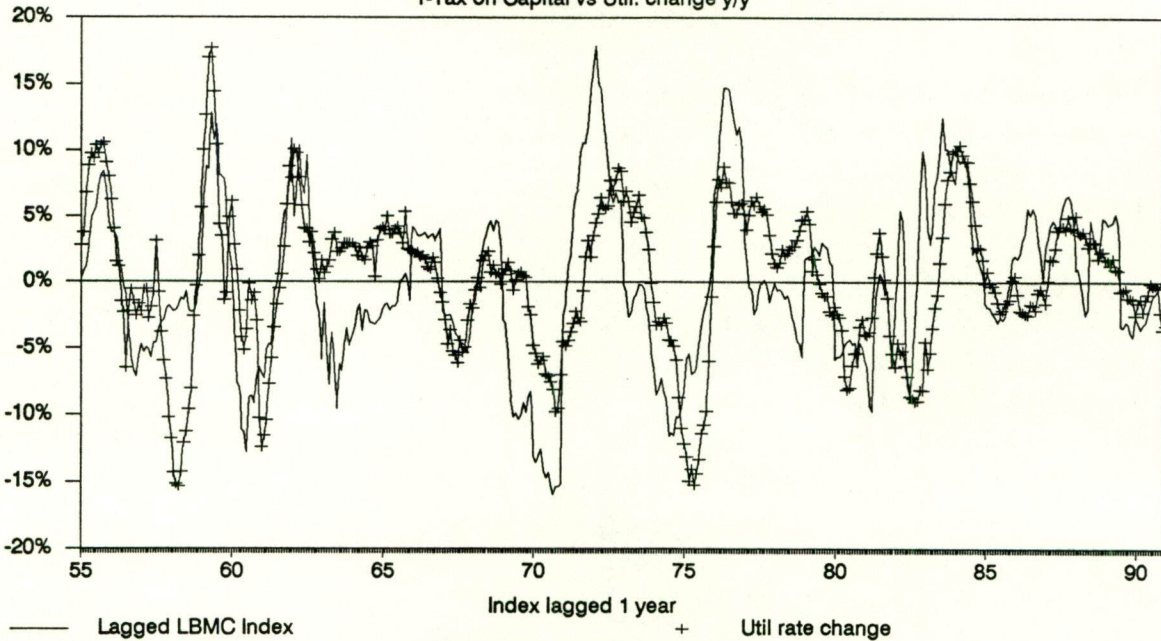
October. Real dollar liquidity points to stronger-than-expected growth into early 1992, then a temporary slowing.

Monetized Federal Debt & Capacity Use



LBMC's Capital Return Index

1-Tax on Capital vs Util. change y/y



Lehrman Bell Mueller Cannon, Inc.

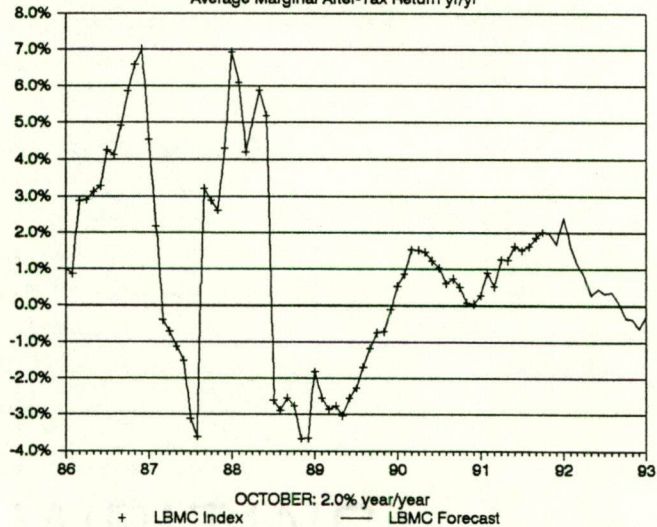
2.2.LBMC Capital Return Index

Explanation. The LBMC Capital Return Index is a monthly indicator of the supply-side effect of Federal tax policy on the return to capital. The index includes Federal taxes on corporate income, personal income, and capital gains. When the marginal tax on capital falls, the index rises. Even without changes in tax law, the tax rate changes each month with the expected inflation rate (since capital gains are not indexed for inflation), and with interest rates (which alter the value of tax deductions for depreciation). Thus monetary policy and effective marginal tax rates are related.

Latest. LBMC's Capital Return Index rose again in October -- up 2% year-to-year, mostly due to the positive effects of falling inflation and lower interest rates. We expect this to be near the peak.

LBMC Capital Return Index

Average Marginal After-Tax Return yr/yr



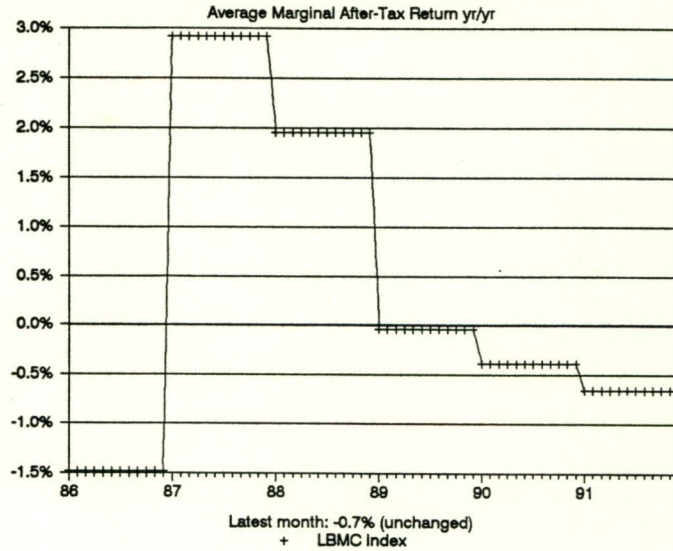
Lehrman Bell Mueller Cannon, Inc.

2.3. LBMC Labor Return Index

Explanation. The LBMC Labor Return Index charts the change in the marginal return to labor after Federal income and payroll taxes.

Latest. The supply-side effect on labor of Federal tax policy remains slightly negative in 1991, largely due to a rise in the top income and Medicare tax rates on January 1.

LBMC Labor Return Index



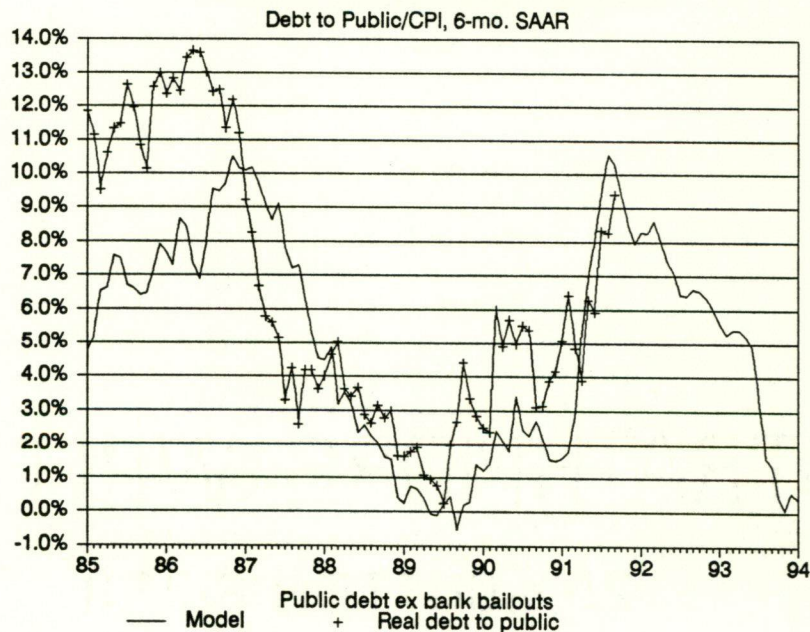
2.4. "Real" Federal Debt

Explanation. We've come to the view that Federal deficits have no major impact on growth unless they are monetized (see Section 2.1). But they can affect the composition of output. Under floating exchange rates, a non-monetized deficit can attract foreign capital, causing the dollar to appreciate. Additional domestic consumption or investment financed by the deficit tends to be offset by a decline in net exports.

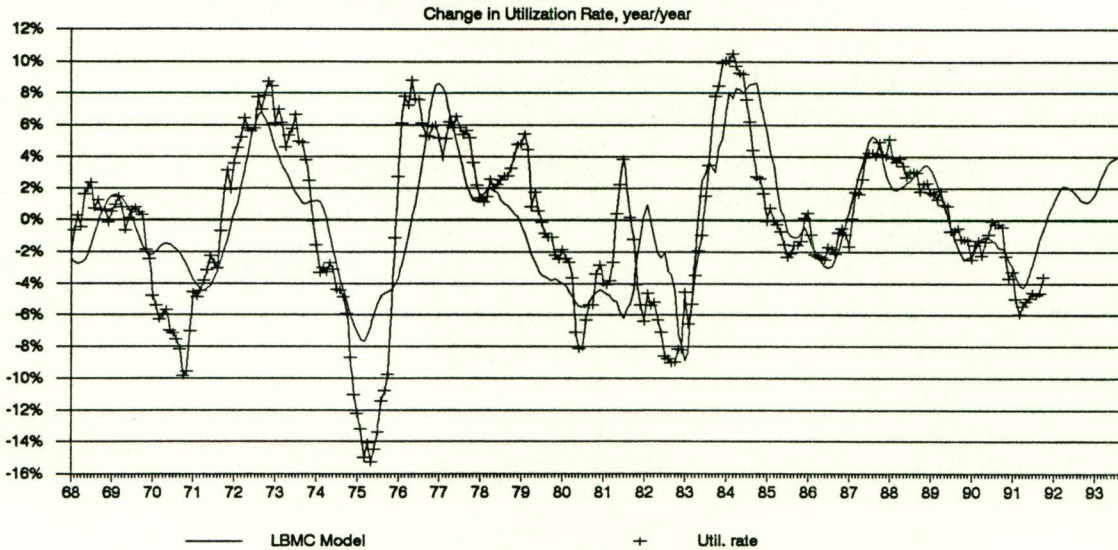
Latest. Just a few months back, the talk was about the declining deficit, thanks to

Gulf War payments; recently it's been about the ballooning federal deficit. As we've argued in recent months, the inflation-adjusted growth rate of Federal debt should soon peak and decline, largely due to the economy's bottoming and recovery.

LBMC's Federal Debt Model



LBMC Growth Model: Almost 2 Years Ahead



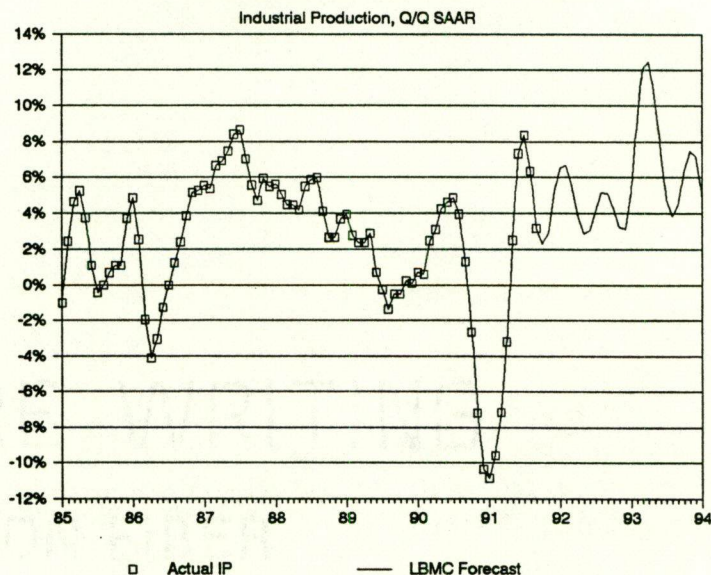
2.5. The LBMC Growth Model

Explanation. LBMC's Growth Model begins with a forecast of the rate of change in capacity utilization, based on the LBMC indexes for government monetary and fiscal policies. This is combined with a forecast of industrial capacity to produce a forecast of industrial production.

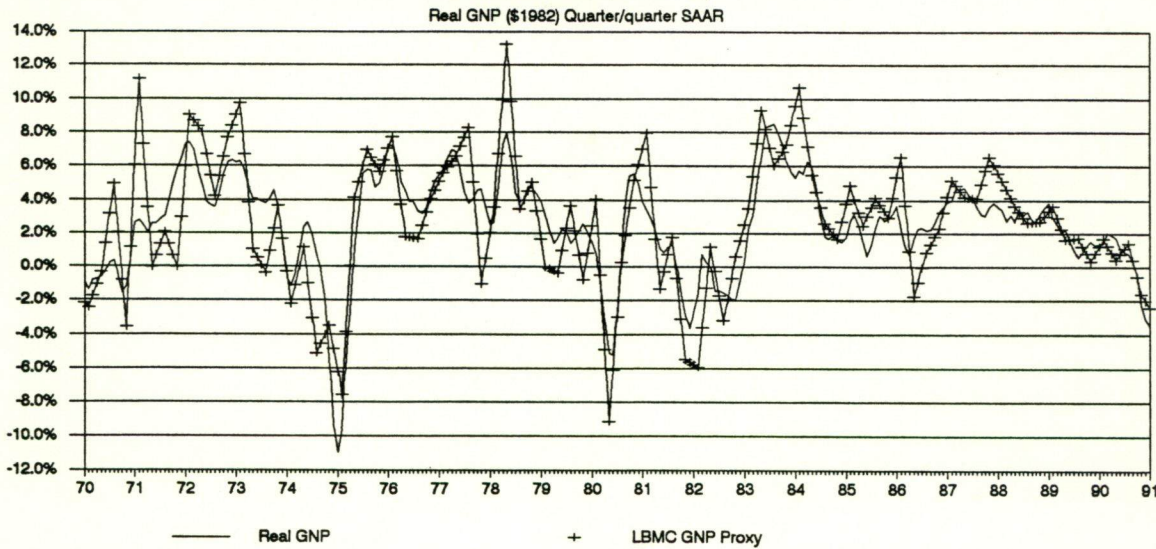
Latest. Industrial production was unchanged in October, though July and September were revised up a bit. If we're right, we should see healthy monthly increases for the next three or four months, confounding the increasingly numerous "double-dippers" who look for declines. We expect quarterly growth rates in in-

dustrial production to register about 3% in the 4th quarter, 6-7% in the 1st quarter of 1992, and 3% in the second. We look for a wave of strong growth at the start of 1993, when capacity use rises sharply (see graph page 2). After declining almost 2% in 1991, output should rise 4-5% in 1992.

LBMC's Growth Forecast



LBMC's GNP Proxy



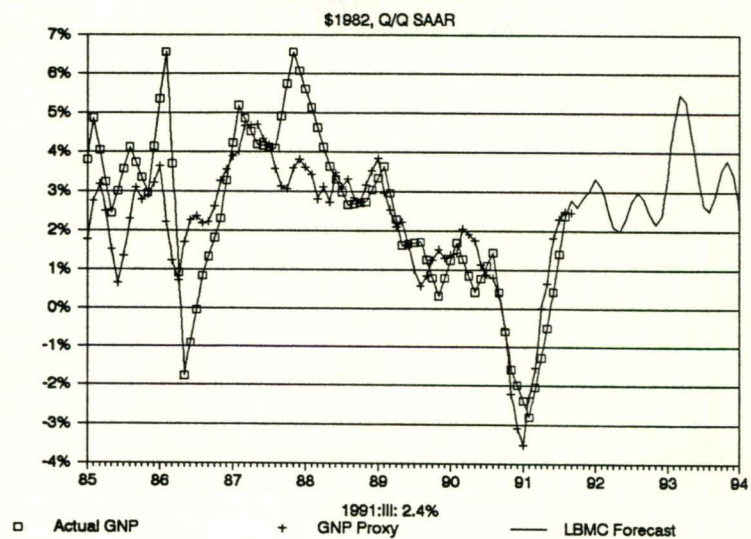
2.6. LBMC's GNP Proxy

Explanation. LBMC's Monthly GNP Proxy is based on industrial production and, starting this month, employment. Though industrial output is the best single proxy for GNP, the forecast can be improved a bit by adding employment to represent the non-industrial economy.

Latest. Our forecast of industrial production has been very close to the mark. But we've overestimated real GNP so far during the recovery. Just as the industrial recession began before the GNP recession, industry has so far recovered sooner than the rest of the economy; and it seems that this will persist for the time being. Leaving our forecast of industrial output unchanged, we're

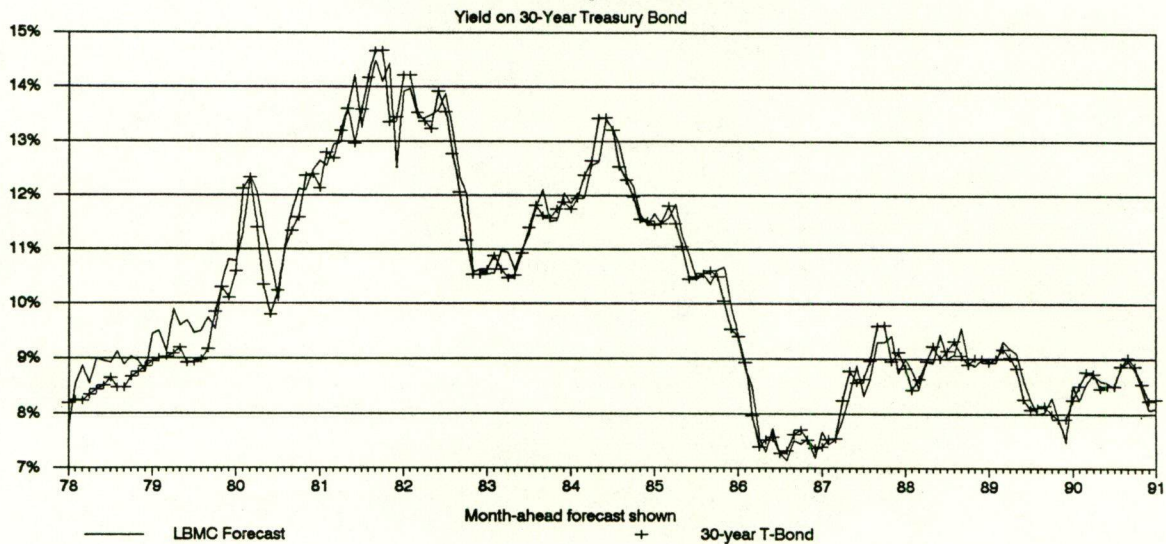
lowering our GNP forecast about 1 percentage point, to 2.9% in the current quarter and 3.1% in the first quarter of 1992, followed by a decline to the 2% range in mid-1992. Growth should spurt to 4% or more in the first half of 1993. Measured fourth-quarter-over-fourth-quarter, real GNP should rise 0.5% in 1991, 2.6% in 1992, and 3.8% in 1993.

Real GNP Growth



3.0. The Outlook For Financial Markets

LBMC's Treasury Bond Model



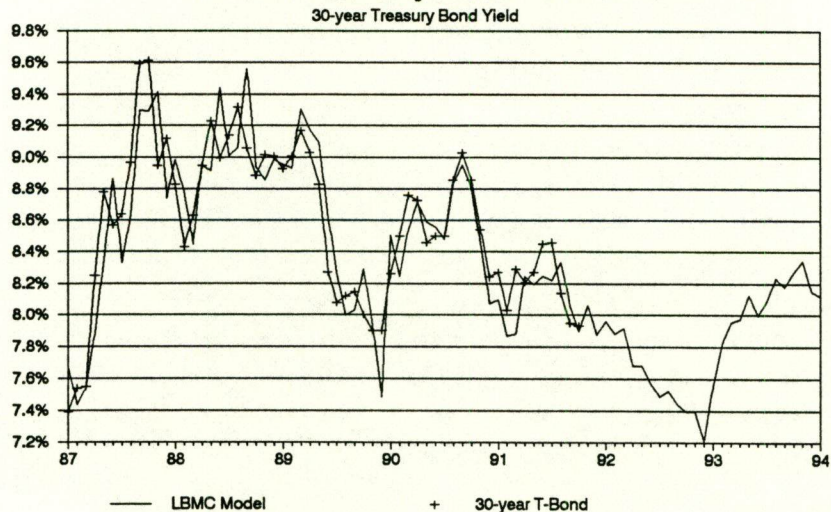
3.1. LBMC Treasury Bond Model

Explanation. LBMC's Treasury Bond Model is designed to forecast the monthly average yield of the 30-year Treasury Bond. The forecast is based on LBMC's forecasts of the economy, central bank policy and investor expectations about inflation and the dollar.

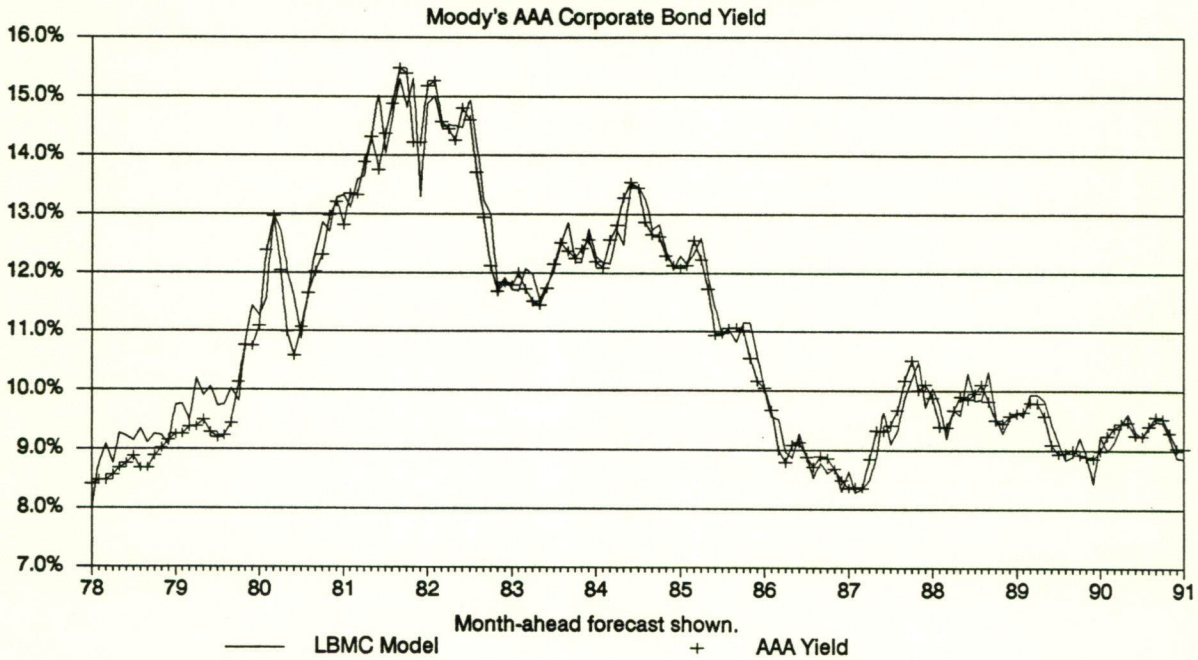
Latest. The 30-year T-Bond yield remained just below 8% for most of November. We expect the yield to stay there a

couple more months as the markets digest better-than-expected news on the economy and a couple of slightly worse CPI reports. But then yields should drop in 1992 to a low of about 7-1/4%, before backing up 100 basis points by early 1993 as inflation rises. Yields should average 7.95% in the fourth quarter of 1991 and 7.60% in 1992.

LBMC's Treasury Bond Forecast



LBMC's Corporate Bond Model



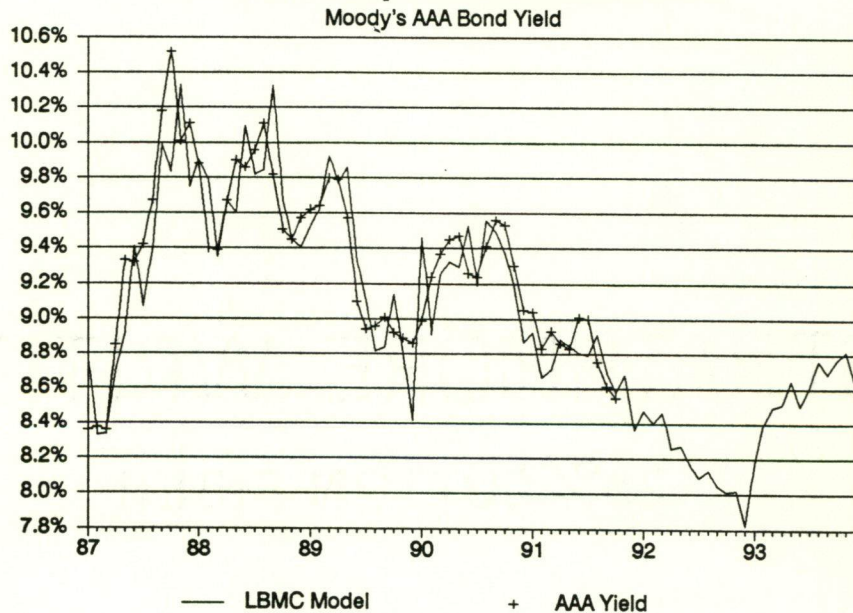
3.2. LBMC Corporate Bond Model

Bond Model, but the general outlook is not greatly changed. We see the AAA corporate bond yield averaging 8.78% in 1991 and 8.18% in 1992.

Explanation. The LBMC Corporate Bond Model is designed to forecast the yield of Moody's AAA Corporate Bond index. The AAA yield forecast is based on a varying markup over our forecast for the Treasury bond yield.

Latest. We've made some technical improvements in our Corporate

LBMC's Corporate Bond Model



3.3. The LBMC Liquidity Index as a Long-Term Stock Guide

Explanation. The LBMC Liquidity Index is a monthly indicator of liquidity growth in the U.S. economy. The banking system, led by the Fed, supplies liquidity, while growth or inflation "absorbs" liquidity.

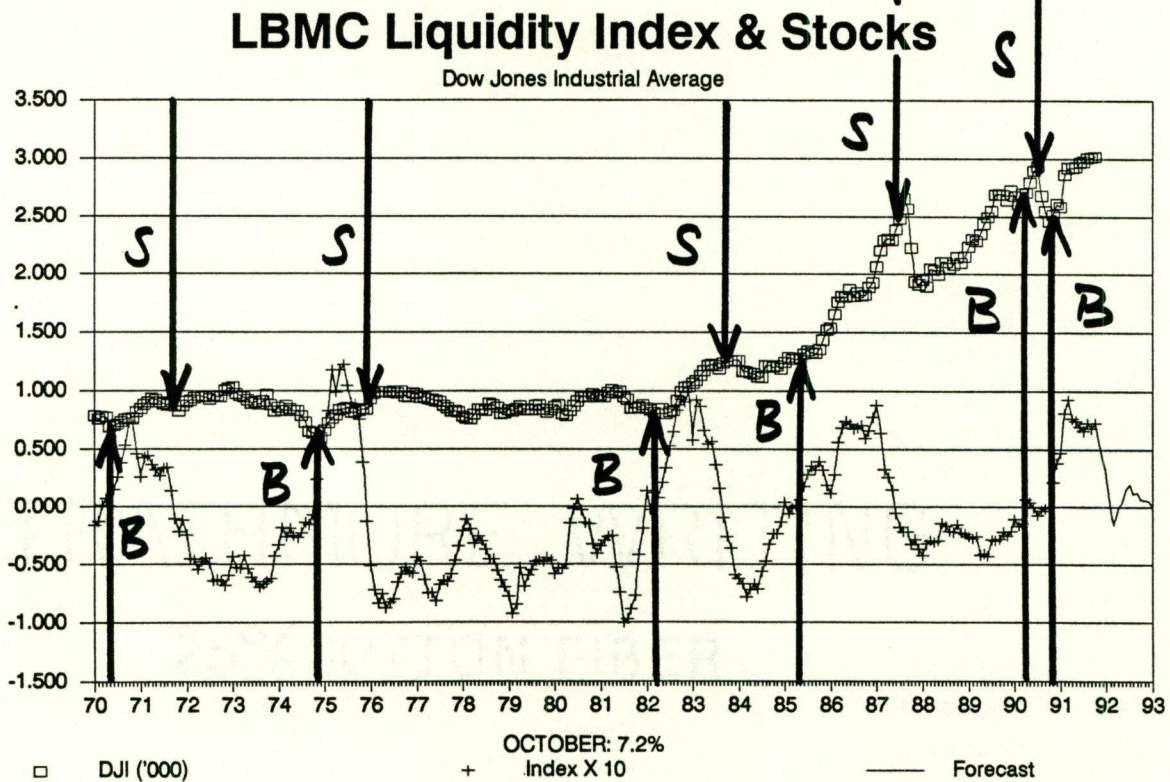
The LBMC Liquidity Index serves as a useful guide for strategic stock investment. When the Liquidity Index turns positive, it acts as a major "buy" signal for stocks; when the Liquidity Index turns negative, it acts as a major "sell" signal.

The LBMC Liquidity Index gives relatively few buy and sell signals. But

in the past using this method has made possible higher returns than buy-and-hold. For the chart below, buy-and-hold would have yielded 286% in capital gains (ignoring dividends and foregone interest), but following the Liquidity Index would have yielded 521%.

Between signals, the Long-Term Index is not intended as a guide for short-term investments. For our near-term outlook, see the following section.

Latest. LBMC's Long-Term Liquidity Index shows liquidity still rising rapidly, but we expect it to fall over the next several months, largely due to year-to-year rises in output, which "absorb" available liquidity.



3.4. LBMC Liquidity Index as a Medium-Term Stock Guide

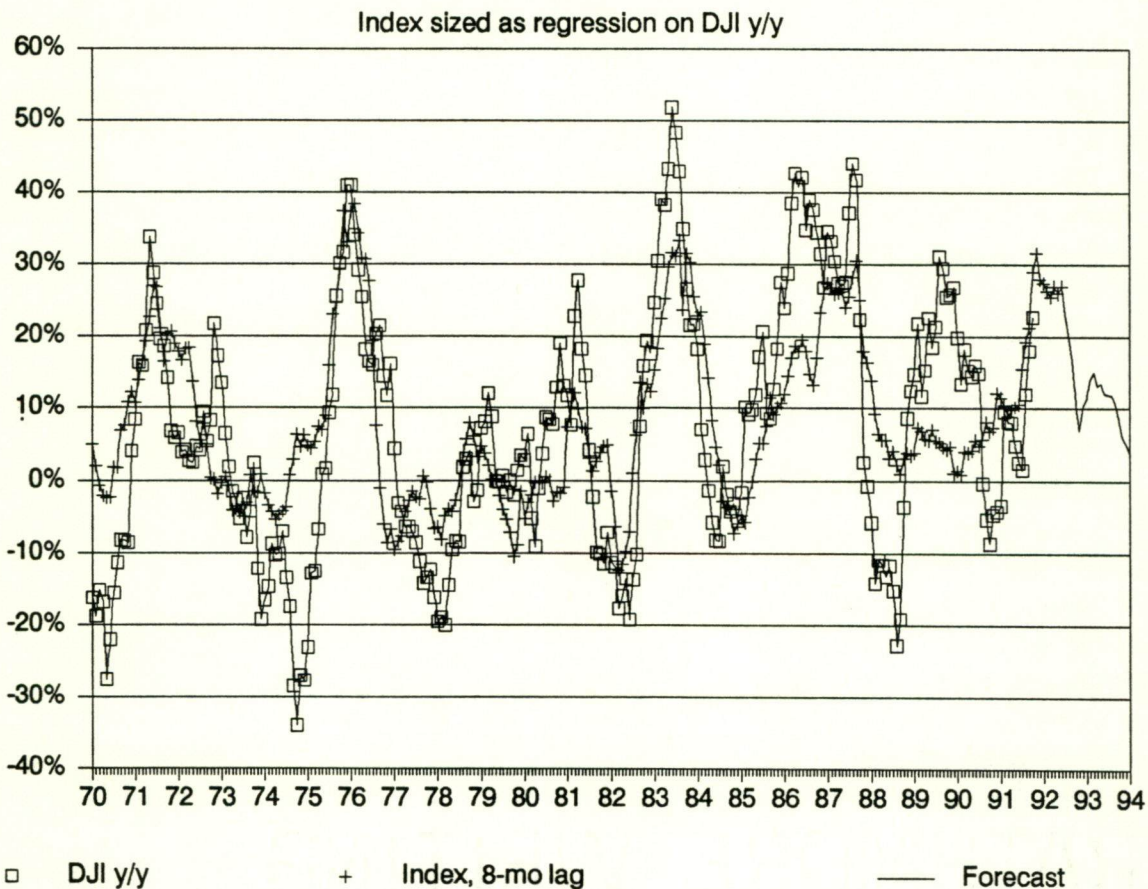
Explanation. The Liquidity Index used in Section 3.3 as a long-term bull/bear market indicator can also be used to gain important information about shorter-term stock market moves.

In this section the LBMC Liquidity Index is rescaled for comparison with the year-on-year increase in the Dow Jones Industrials. The LBMC Liquidity Index leads the stock market by about six

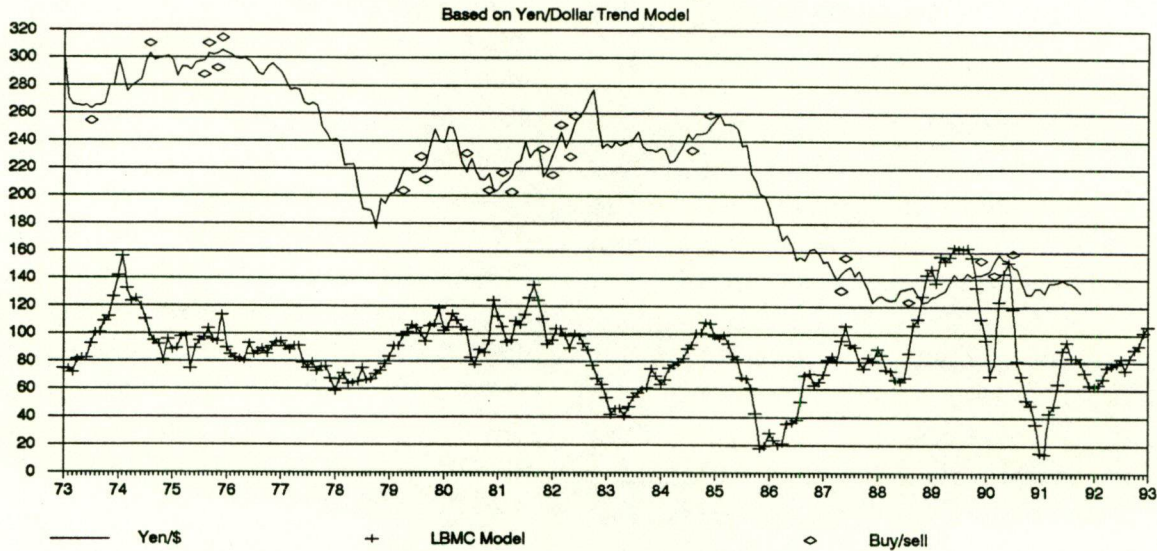
to eight months. Being based purely on liquidity, the index does not directly include such influences on the stock market as valuation, taxation, leverage, exchange rates or investor expectations.

Latest. November's 120-point correction in a single day was unnerving, and traditional valuation measures are on the high side. Nevertheless, because we expect continued recovery and a larger bond rally over the next year, we are raising our target for the Dow Jones Industrials, to peak at about 3,800 by the end of 1992.

LBMC Liquidity Index & Change in Stocks



LBMC's Yen/Dollar Signal

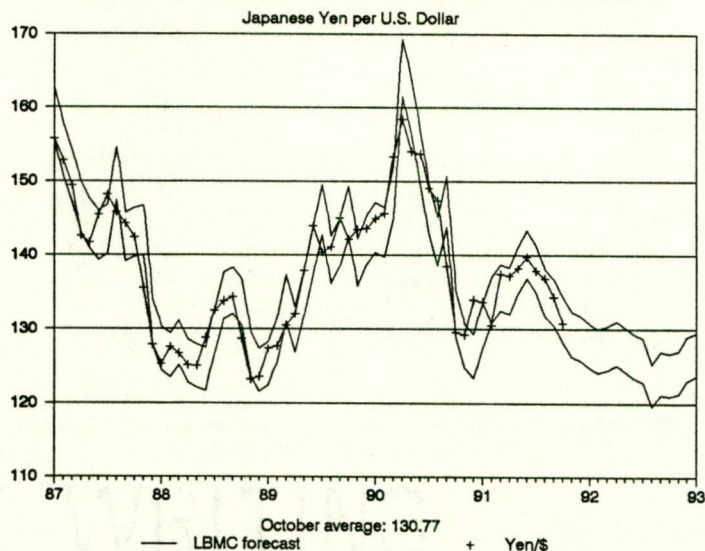


Section 3.5. LBMC's Yen/Dollar Forecast

Explanation. LBMC's Yen-Dollar Trend Model is designed to help determine turning points in the yen/dollar exchange rate. The basic factors in the forecast are central bank policy and the terms of trade. The top graph shows how the model can be used as a buy/sell signal. A buy (or sell) is indicated when the model's rate of change turns positive (or negative); the zero line is shown here as 100. The graph below translates the economic fundamentals of the model into a forecast for the actual yen/dollar rate, taking into account the "bandwagon effect" of trend-followers. The forecast "band" reflects the confidence limits of a 1-month-ahead forecast.

Latest. We've recalibrated the model slightly, but the forecast is still for the dollar to decline to the low-120- yen range by mid-1992, then recover into 1993. Despite November strength of the Deutschemark, which we did not anticipate, fundamentals including Germany's inflation problem still point to a rise of the dollar against the DM.

LBMC's Yen/Dollar Trend Forecast





CAPITOL COMMENT

A TIMELY PERSPECTIVE ON CURRENT PUBLIC POLICY.

No. 70

March 13, 1991

Economic Planes / Incentive effects

STEWARDSHIP AND ECONOMIC GROWTH

Just as campaigns for elected office are won and lost at the margins, so is long-term economic growth. Winning at the margins for economic growth may not seem like very much on a case-by-case basis. But the sum total of efforts to enhance productivity, investment, and savings will enrich everyone in the long run.

Many advocates for policy change frequently ignore the effect their policy proposals have on the growth of gross national product (GNP), our broadest measure of prosperity. In the long-run, though, policy changes that result in seemingly small differences in the rate of economic growth will substantially change the well-being of future Americans. In many respects, the prosperity of future generations depends on good stewardship today.

No one can precisely quantify the difference between economic policy that leads to stagnation (high taxation, over-regulation, and protectionism) and that which leads to growth (low taxation, deregulation, and free trade). But if we could, and the hypothetical difference was between a 2 percent versus a 4 percent GNP growth rate, many people would discount that difference as too small to worry about. But is it?

Table 1 contrasts the effects of a 2 and 4 percent growth rate on the standard of living of our children and grandchildren. If misguided economic policy leads to only 2 percent growth annually through 2016, our children would have a standard of living 63.5 percent above ours today.

Table 1

THE STEWARDSHIP EFFECT: COMPARISON OF GNP GROWTH RATE OVER TIME

Example of 2 percent vs. 4 percent real GNP growth rate in 25 year intervals (constant 1991 dollars)

| <u>Year</u> | <u>2 percent rate of GNP growth (in billions)</u> | <u>4 percent rate of GNP growth (in billions)</u> | <u>Percentage Difference</u> |
|-------------|---|---|------------------------------|
| 1991 | \$5,521.3 | \$5,521.3 | 0.0 |
| 2016 | \$9,026.2 | \$14,677.2 | 62.6 |
| 2041 | \$14,776.5 | \$39,085.5 | 164.5 |

But if our annual rate of growth is 4 percent, their standard of living would be 165.8 percent greater than today's, or 62.6 percent better than if the economy grows at 2 percent. When our grandchildren come of age, an economy expanding at 4 percent annually would provide over two-and-one-half times the standard of living than an economy growing at only 2 percent each year.

No single piece of legislation can guarantee a high rate of economic growth; there is no silver bullet. But the following legislative initiatives would make a difference at the margin, thereby letting the economy grow at a healthier rate.

o **LOWER TAXES ON LABOR.** The Wallop-DeLay-Tallon bill (S. 381/H.R. 960) would cut the Social Security payroll tax rate until Social Security tax revenues fall to match Social Security expenditures. Such a tax cut would lower the marginal tax rate for working people and cut the cost of hiring additional workers, leading to increased employment.

o **LOWER THE TAX ON CAPITAL GAINS.** High capital gains tax rates raise the cost of capital to American businesses, discourage investment, and hurt economic growth. The Wallop-DeLay-Tallon bill cuts the maximum capital gains tax rate from 28 percent to 15 percent; it also reduces the capital gains rate to 7.5 percent for those in the 15 percent income tax bracket.

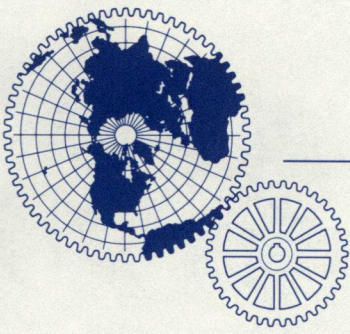
o **LOWER TAXES ON SAVING.** Economists agree that the level of saving in an economy is one of the crucial determinants of its health. The Wallop-DeLay-Tallon bill would create an attractive savings vehicle called "IRA-Plus" accounts.

o **CAP THE GROWTH RATE OF OVERALL FEDERAL SPENDING AT 4 PERCENT ANNUALLY.** If the "4 Percent Solution" had been implemented in fiscal year 1983, we would be running a surplus in the budget and the national debt would be one-third its size. Congress should pass legislation similar to last year's Burns-Armey-Kasich bill.

o **HOLD THE LINE AGAINST THE RISING TIDE OF MANDATED BENEFITS.** The costs of mandated benefits are a substantial burden on the economy. Mandated benefits distort markets while hampering America's ability to compete.

o **PRESS TOWARD ESTABLISHING A NORTH AMERICAN FREE TRADE ZONE.** Increased trade would create jobs in U.S. industries by expanding exports and would cut consumer costs through cheaper imports.

J. Marc Wheat
Director of Tax & Budget Policy

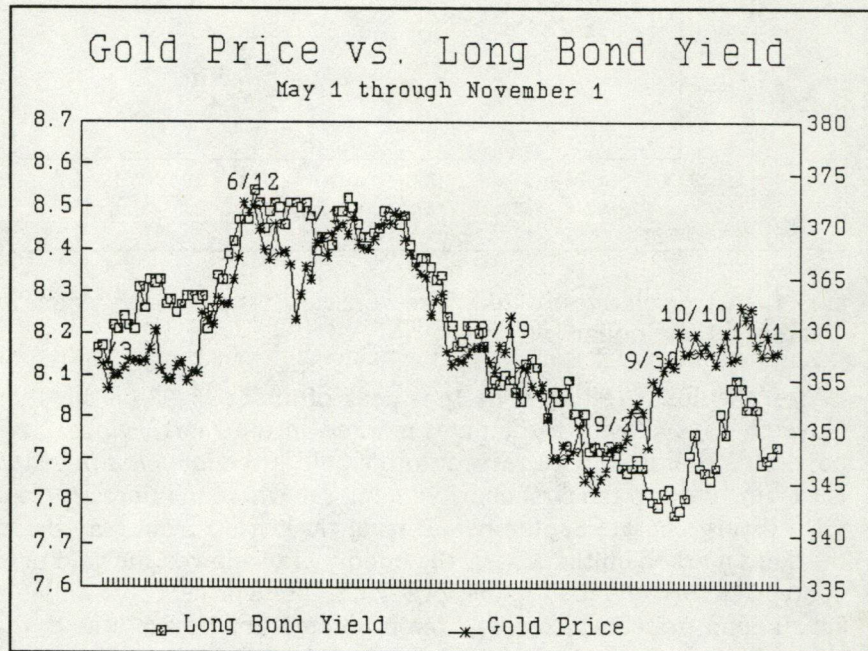


November 7, 1991

WORRIED ABOUT GREENSPAN

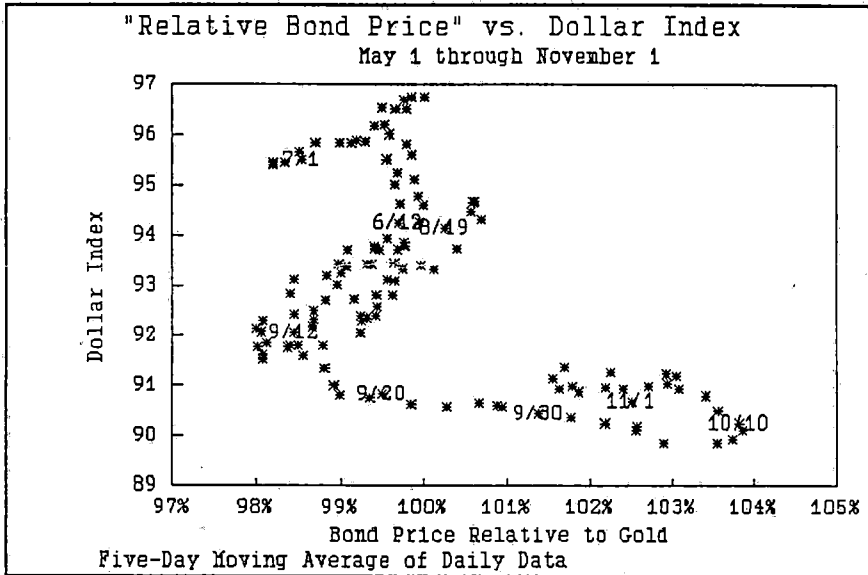
Yesterday morning's discount rate cut left the long Treasury bond just marginally higher after an initial rally. The dissipation of the bond's early gains seems to have coincided with news that Federal Reserve Governor Wayne Angell disagreed with the decision. Governor John LaWare also resisted the easing, according to press reports this morning, but ultimately voted with the majority. Forcing the federal funds rate below 5% makes no economic sense at this point, and raises fears that Chairman Greenspan has succumbed to political pressures. U.S. bonds and stocks are vulnerable to a substantial downward correction if the global market perceives a shaky hand at the monetary rudder.

The market is now especially vulnerable because investors have given the Fed Governors the benefit of the doubt during the past six weeks, buying bonds *at a higher price than the behavior of the gold price would dictate*. As the adjoining chart shows, bonds and gold tracked each other with great precision from early May to mid-September. After that, the bond yield continued to fall, while the gold price stabilized and rose slightly.



Investors were willing to buy bonds at a premium relative to gold for two reasons. First, the market came to expect that the Fed Governors would take action to keep the gold price within a narrow trading range; that is, it responded not only to the absolute level of the gold price but to its volatility, as we have noted on various past occasions. Second, global investors anticipated that a recovery of the dollar would provide capital gains in dollar bonds, and the anticipated rise of the dollar was factored into bond prices. Most of the discrepancy between the predicted and actual bond yield, our studies show, may be attributed to *expected changes in the dollar's value against foreign currencies*. The global market will buy dollar bonds when the dollar seems cheap against foreign exchange, i.e., when the market expects future dollar appreciation, and vice versa. The market will also purchase dollars when dollar bonds seem cheap, and vice versa. Examining this relationship helped us identify the February trough and June peak of the dollar (FYI's, 2-11-91 & 6-13-91). One might well ask why investors would buy bonds rather than dollar options in expression of this expectation. The answer is that the *timing of expectations is often uncertain*. Whereas currency options require precise timing, relative shifts in bond portfolios do not.

If expectations of a dollar rally evaporate, the long bond will be in for big trouble. The long bond yield fell to a low of 7.78% on October 7, when the dollar stood close to its four-month low. The dollar had just begun to recover when Treasury Secretary Nicholas Brady turned up in Tokyo en route to the Bangkok International Monetary Fund meeting and demanded that the Japanese engineer an appreciation of the yen against the U.S. dollar, supposedly to benefit the U.S. balance of trade position. Brady's attempt to devalue the dollar marked the end of the bond rally, as we warned at the time ["Budget Agreement: Breaking the Ice," 10-8-91].

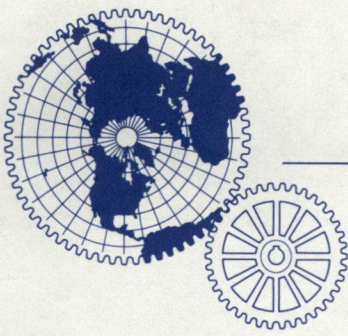


The adjoining chart summarizes the way in which the global market factors currency expectations into the price of the long bond. The horizontal axis shows the actual bond price as a percentage of the predicted bond price (based on the gold-bond correlation). When this measure stands above 100%, bonds are cheap in terms of gold (the bond yield is lower and the bond price is higher than the gold price would predict it would be). When the index stands below 100%, bonds

are expensive relative to gold. The vertical axis shows the dollar's value, according to the Morgan Guaranty Trust dollar index.

After the dollar fell from its June peak of about 96-98 on the dollar index to 90-92 in October and November (as shown in the dates marked in the chart), global investors were willing to buy dollar bonds at a premium with respect to the gold price, *anticipating capital gains as the dollar recovered*. Referring back to the first chart you will see where the lines representing the gold price and the bond yield diverge in late September. During the period from May through mid-September, as shown in the dates marked on that chart, the bond yield followed the gold price quite closely, that is, the actual bond price corresponded to the "predicted" bond price. From mid-September through the present, the actual bond price has *exceeded* the predicted bond price, due to the market's expectations of dollar appreciation, as noted above. If the Board of Governors thwarts these expectations, and leads the market to believe that the dollar will continue to weaken, investors will *deduct* the currency factor from the bond price, pushing the long bond yield to 8.20% or even higher. Chairman Greenspan is playing with dynamite when he encourages the market to believe that he is conducting monetary policy on behalf of George Bush's political criteria. We hope that no such thing is the case. With no clear assurances from the Board of Governors, though, we can only recommend caution.

David Goldman



November 11, 1991

ECONOMIC OUTLOOK: A MARKET-BASED GROWTH EXPECTATIONS INDEX

A new index of the stock market's growth expectations shows the economy dead in the water, with the market anticipating neither economic growth nor decline. (An index level of 1 means no change with respect to the starting date of August 1, 1990, when real GNP growth was crawling along at 1%). By this index, the market's growth expectations hit bottom just before Operation Desert Storm began in January, and peaked last August before heading back to the 1.0 mark. Our measure has important political implications: it forecasts a likely election defeat for President Bush next year, and corroborates the views of those in the administration, e.g., HUD Secretary Kemp, who argue that action is necessary to stimulate growth. The President's economic advisors have told him that the 2.5% growth they expect will be more than sufficient to ensure his re-election. As matters stand, even 2.5% real growth appears unlikely between mid-1991 and mid-1992.

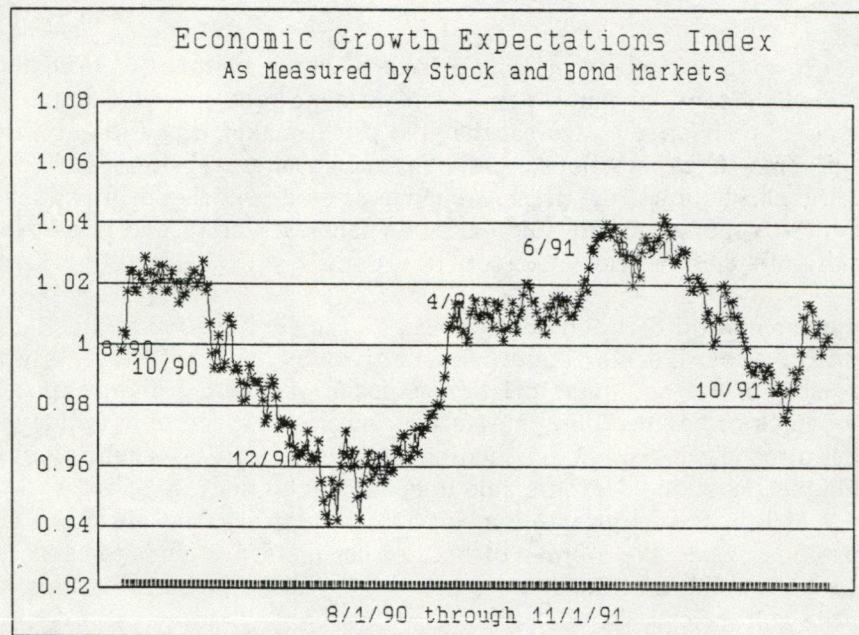


Chart 1

Market-based models of the kind shown in the above chart work well only under highly specific circumstances; this one depends upon the peculiar effect of inflation on the real rate of capital gains taxation. In the present tax and monetary environment, the problem is to distinguish between the effect of *growth expectations* and *inflation expectations* upon securities prices. We have always believed that stock prices provide the best index of growth expectations. Earlier this year, we documented the stock market's uncannily precise ability to forecast the *relative strength of economic recoveries* during the past three decades, ["Economic Outlook: Will Easier Money Help the Economy Recover?" 5-9-91]. The growth of *real* stock prices during the first year of each recovery corresponded closely to real economic growth during the last four recoveries. Today's high rate of taxation of nominal capital gains, though, makes it harder to infer growth expectations from stock prices. As we have emphasized, *most of the change in stock prices during the past year simply reflects changing inflation expectations*. Lower expected inflation equals a lower expected *real* tax rate on capital gains, and thus higher asset prices. The correlation between changing inflation expectations (i.e., the gold price) and stock prices has been so strong that it is hard to know how much of the movement of stock prices should be attributed to changes in expectations of real economic growth, as opposed to inflation.

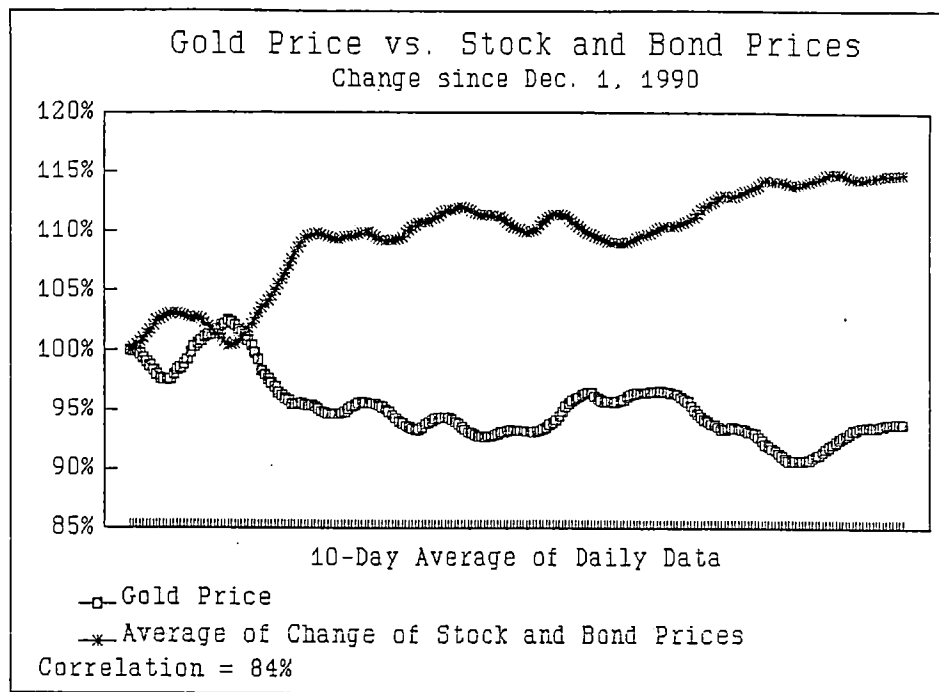


Chart 2

The above chart shows the change in the gold price against the average of the change of the Wilshire 5000 index and the Shearson-Lehman index of government bond prices. Comparing the change of stock and bond prices, respectively, against the gold price, makes it possible to factor out inflation expectations from growth expectations, and construct a more-or-less "pure" index of growth expectations. As the chart shows, the *average* change of stock and bond prices shows an extremely close correspondence to changes in the gold price. As gold rises, stock and bond prices fall, and vice versa. The correlation is 84%, a nearly perfect fit.

Remarkably, the correlation between gold prices and the *combination* of stock and bond prices is much higher than for either stock or bond prices individually. That, in fact, is what theory would predict. Stock prices reflect not only inflation expectations, but growth expectations; thus, the correspondence of stock prices to a "pure" measure of inflation expectations (gold) should be less than 100%. Bond prices also reflect growth expectations, albeit *negatively*. When investors expect higher growth, secured lenders (bondholders) are able to demand a higher rate of return. *Real* interest rates rise, and bond prices fall. Rising growth expectations have a *negative* effect on bond prices and a *positive* effect on stock prices; the *average* of both prices therefore tends to cancel out the effect of growth expectations, leaving an almost pure reaction to inflation expectations, and a very high correlation with the gold price.

To isolate the *growth* component of stock and bond prices, we first took the linear regression of gold vs. stock and bond prices, and then reconstructed the expected inflation (gold price) *predicted* by the correlation with stock and bond prices, respectively. The ratio of the inflation predicted by stock and bond prices, respectively, as shown in Chart 1, is the market's anticipation of economic growth or decline; the inflation component is eliminated from the change of stock and bond prices, leaving as a residual their response to anticipated economic growth.

David Goldman

RACE



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LBMC Report October 25, 1991

The Black Republican Surge

Conclusions of importance to business and investors: The major unreported fallout of the Clarence Thomas confirmation struggle is a surge toward George Bush and the Republican Party among black voters. Elements of the political and media elite are well aware of this trend, but have different reasons for failing to publicize the data in their own national polling. Liberals are hoping that black anger at Democrats is a temporary phenomenon, quickly reversible by Republican stumbles on civil rights and/or economics. Elated White House strategists, in contrast, are rushing to compromise on the pending civil rights bill while renewing the attack on the congressional handling of the Thomas nomination before the public is able to focus on the new polling. Two additional fallouts: impending further demoralization in Democratic presidential ranks, and a desire among Democrats in Congress to change the subject toward the economy via passage of a broad-based tax cut in 1992.

During the electrifying struggle over the Supreme Court confirmation of Clarence Thomas, the one thing conventional wisdom "knew" was that the political fallout would divide along gender lines. Men would be more tolerant of the sexual harassment charges being brought by former Thomas assistant Anita Hill, while women, drawing on their own experiences and those of their friends, would tend to believe Ms. Hill and turn their wrath on male politicians such as President Bush and the members of the Senate Judiciary Committee.

No one watching network television or reading the op-ed pages could be blamed for believing this to be true of public opinion in the nation at large. If televised reactions and high-profile opinion and analytical writing were either the engine or the reflection of public opinion, the gender gap would be wider than ever and Democrats would have a superb new "women's issue" for the 1992 campaign.

Within days, political and media elites knew from their polling that nothing of the kind had happened. Women's

support for the Thomas nomination was a little less than men's support, but still overwhelming. President Bush was doing better among men than women against his potential Democratic opponents, but not much better. The gender gap is somewhat less than it was under Ronald Reagan and not statistically different from Bush's victory over Michael Dukakis in 1988.

What leapt out at Washington's insiders was Bush's strength among blacks. In a fresh Gallup match-up against his best-known potential opponent, New York Governor Mario Cuomo, Bush wins 44 percent of the black vote against Cuomo's 46 percent. In 1988 among the same voters, Dukakis defeated Bush by 88 to 10 percent, according to ABC's exit poll.

Put another way, in 1988 Bush won 54 percent of all voters and 10 percent among blacks. The disparity between blacks and Americans as a whole in degree of Republican support apparently has shrunk from 40-50 percent in the Reagan-Bush years to under 20 percent now.

Looked at still another way, Bush has roughly as many white voters leaning his way against Cuomo as he got on election day against Dukakis. Most of his national gain (from 54 percent in 1988 to 63 percent now) comes from a *quadrupling* of his support among blacks.

At a time when Bush is under growing fire for his focus on foreign policy at the expense of such domestic issues as the economy, the post-Thomas numbers coming in from Gallup and other pollsters have provided sweet music to

White House ears. Little wonder that in the first full week following Thomas's October 15 confirmation, Bush and his top aides devoted the bulk of their efforts to an attack on Thomas's treatment by the Senate and to finding a compromise on civil rights acceptable to Senate liberals--*not* to an attempt to craft an Administration growth package in response to the flood of new Democratic tax cut proposals. With the Republican surge among pro-Thomas blacks, the last thing the Administration wants is a change of subject. Especially not to a subject where Washington's civil rights lobbyists would have a chance to portray Bush as insensitive to blacks.

For the Democrats, alienation from black voters is their worst nightmare. Blacks have been the unassailable Democratic base vote in the vote-rich Northern and Western swing states (Illinois, Michigan, California, etc.) which Democrats must carry to ever regain the Presidency. If Republicans became competitive with black voters, Democrats would need a share of the white vote comparable to their showings in such landslide years of the past as 1936 and 1964.

Democratic presidential candidates have every reason to hope that the Thomas controversy passes quickly from the news. But even after it does, the Bush campaign will find it easy enough to resurrect: all six declared candidates for the Democratic nomination went on record as opposed to the Thomas nomination. The best-known undecided candidate, Mario Cuomo, not only opposed Thomas but attacked Democratic members of the Judiciary Committee for not questioning Thomas

more aggressively. Given Thomas's firm support among white voters and even stronger approval among blacks, it is safe to say that Cuomo has not heard the last of this issue should he decide to run.

Democratic congressional incumbents will not spend much time mulling over the effects of the Thomas fight on their presidential candidates. A weak top of the ticket endangered few Democratic incumbents in 1984 or 1988. Their greatest fear is that the public is beginning to focus on disapproval of Congress as an independent issue. Within hours after Bush's call for an independent counsel to investigate the Thomas leaks, the Senate had passed a similar resolution. In the wake of publicity on check kiting and unpaid restaurant bills, the last thing Congress needs is to look obstructionist on tracking down the leaks on Thomas.

What congressional Democrats do need is a change of subject. It was no accident that for ten full days after the Thomas vote, all Democrats seemed

to want to talk about was tax-cut packages, some of them quite large.

As we predicted at the beginning of this Congress (**LBMC Report**, February 1991, "The Next Tax Bill"), the ingredients are coming together for a broad-based package of stimulative tax cuts, including pro-family tax relief, IRA expansion, and capital gains reform, probably paid for by some combination of defense cuts and loophole plugging. Democrats have every interest in shifting toward an issue (the economy) that has been a severe Bush weakness, and once tax legislation picks up steam (probably in the first half of next year) the Administration will have every interest in coming to a compromise that will go a long way toward taking the economic issue out of presidential politics. If this happens, the big loser will be the Democratic presidential nominee. But in the post-1968 era of split government, that has never much bothered congressional Democrats, and in this regard 1992 should be no exception.

SNPA

Southern Newspaper Publishers Association
P.O. Box 28875 / Atlanta, Georgia 30358 / (404) 256-0444

SOUTHERN NEWSPAPER PUBLISHERS ASSOCIATION

Members are 420 daily newspaper owners and publishers in 15 Southern states. SNPA is headquartered in Atlanta.

This is our 88th annual meeting. 560 delegates are present.

President: Ashton Phelps, Jr., publisher, The New Orleans Times-Picayune. (Ashton and the President have played tennis).

Other officers and directors attached.

SNPA, through its charitable foundation, provides a wide range of informational and educational services to newspapers and their staff members throughout the South.

MAIN ISSUES THAT CONCERN SOUTHERN NEWSPAPERS

1. Regional Bell Operating Companies and their monopolization of electronic information services. This is our MAJOR issue. We will be discussing it and H.R. 3515 - The Cooper Bill.
2. The Economy. Newspapers have had the worst two financial years in recent history in 1990 and 1991. We'll be discussing how we can survive as strong, vibrant businesses despite this situation.
3. Press coverage of minority issues - how can we do it better?
4. Diversifying our services by delivering non-newspaper products to homes in our areas.

We will also be discussing journalism education and personnel issues, including employee health care.

OTHER ITEMS OF INTEREST

Defense Secretary Cheney will have visited and spoken to us on Monday, November 18.

William Dillard, founder of Dillard Stores (Little Rock, Arkansas) was also a featured speaker. Other special guests include Edward DeBartolo, one of the largest developers in the United States and Al Neuharth, founder of USA TODAY and Chairman of the Freedom Forum.

THE WHITE HOUSE
WASHINGTON

*President -
Campaign 92*

Date: 12/02/91

TO: TONY SNOW

FROM: DAVID M. CARNEY
Special Assistant to the President and
Director, Office of Political Affairs

FYI. I thought you might be interested in the attached newsletter which was forwarded to this office by Thomas Schwieger, President of the Greater Manchester (NH) Chamber of Commerce.

NEWS

GREATER PROVIDENCE CHAMBER OF COMMERCE

Startling Number of Businesses in New England Exploring Relocation Potential

President Bush Called "Not Responsive" to Region's Problems

November 21, 1991
11 a.m. Release

Contact: Laurie White
Sandi Seltzer
521-5000

An extensive survey of businesses throughout New England has found that an alarming 40 percent have considered relocating outside the six-state region. The study also finds that the vast majority of companies have no plans to expand their workforce over the next six months—both ominous signs for a region battered by the ongoing recession.

Those are among the results of an economic outlook survey conducted by the New England Association of Chamber of Commerce Executives in conjunction with Research Results/The Survey Center Inc., based in Leominster, Massachusetts.

During the month of October, **55,662** companies belonging to 69 chambers of commerce throughout the region were questioned on such issues as the credit crunch, the recovery timetable and President Bush's responsiveness to the unique economic needs of New England. Approximately **8,270** completed surveys were tabulated from companies employing more than **625,000** workers. The study has a margin of error of plus or minus 2 percent.

"The survey reveals that the New England business community is quite pessimistic about the region's prospects for recovery," said James G. Hagan, president of the Greater Providence Chamber of Commerce and president of the New England Association of Chamber of Commerce Executives. "In fact, the level of pessimism is so profound that four out of every ten businesses who responded to our survey have considered relocating their operation outside New England. This should send a wake-up call to our elected officials that there are some real public policy inadequacies that need to be addressed region-wide."

Businesses based in Rhode Island, Connecticut and Massachusetts register the strongest potential for relocation. They cite high taxes, high workers compensation costs, a poor government attitude toward business, and the anemic economy as among the reasons for their dissatisfaction.

On a positive note—the availability of skilled and unskilled labor, quality telecommunications services, first-class institutions of higher education, and an abundance of cultural opportunities are among the factors that make New England a desirable place to do business, according to the survey data.

When asked about the short-term prospects for the economy, the average respondent believes the current New England recession will continue for another 19 months. A mere 14 percent anticipate their state's economy will improve in the next year, while 32 percent expect further deterioration. Fifty-four percent say the economy will stay about the same.

Respondents from Maine and Vermont are slightly more optimistic and predict, on average, that the recession will last another 17 months. Companies based in Connecticut—where a personal income tax was recently instituted—are the least optimistic.

OTHER FINDINGS:

- An overwhelming 73% of survey respondents say President Bush "has not been responsive" in resolving New England's unique economic problems; 26% say they believe he has been "somewhat responsive," while 1% characterize his actions as "very responsive."
- Only 16% plan to expand their workforce in the next six months; 77% say they will not hire additional workers; 7% don't know.
- 49% say their company's financial position is "worse" today than it was a year ago; 23% say it is "better"; 28% say it is "no different."
- Less than one-quarter, 24%, plan to expand their plant/facility or make any significant capital expenditures in the next two years; 50% have cancelled or postponed significant capital expenditures in the past six months.
- 69% say the current economic downturn is the "worst" they have ever experienced; 14% say it is the "same"; 4% believe it is "milder"; 13% don't know.
- 82% think now is a good time to buy a home; 53% feel it is a good time to buy a car; and 45% believe it is an opportune time to buy commercial real estate.
- Much has been written about the New England credit crunch: 61% of businesses responding say they have not been "unjustly denied" credit; 39 percent, however, believe they have been unjustly denied credit due to tightened lending standards.
- 86% say it is more difficult now to obtain a commercial loan. Respondents from Maine and Vermont report somewhat less difficulty in obtaining commercial loans.

- 63% are in favor of extending state loan guarantee programs to help alleviate the credit supply problems of businesses in need of short and medium term financing.
- Only New Hampshire is rated by a majority of respondents as being a "pro-business" state. Connecticut is viewed as the most "anti-business" state.
- 79% of companies responding offer health care coverage to their employees; 42% pick up the entire cost.
- 59% support the creation of a New England business promotion office in Europe.
- 63% feel the labor union movement has too much influence over public policy decision making in New England.

The project was underwritten by Fleet/Norstar Financial Group, the certified public accounting firm of KPMG Peat Marwick, and the law firm of Hinckley, Allen, Snyder & Comen.

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New England Chamber of Commerce 1991 Economic Study

[GREATER MANCHESTER] CHAMBER OF COMMERCE

ECONOMIC OUTLOOK

Question 1: How much longer do you expect the current New England recession to last?

| | ===== | | | | |
|--------------|--------|--------|-------|-------|-------|
| | 1 - 6 | 6 - 12 | 1 - 2 | 2 - 3 | > 3 |
| BASE: | MONTHS | MONTHS | YEARS | YEARS | YEARS |
| | ----- | | | | |
| Your Chamber | 131 | 4% | 16% | 45% | 12% |
| Your State | 708 | 5% | 21% | 47% | 8% |
| New England | 7940 | 5% | 23% | 47% | 8% |

Question 2: In terms of your state's economy over the next twelve months, do you expect it to . . . ?

| | ===== | | |
|--------------|---------|------------------------|-------------|
| | IMPROVE | STAY ABOUT THE SAME | DETERIORATE |
| BASE: | ----- | | |
| Your Chamber | 135 | 13% | 36% |
| Your State | 717 | 15% | 29% |
| New England | 8222 | 14% | 32% |

Question 3: Does your company plan on expanding its workforce within the next six months?

| | ===== | | |
|--------------|-------|-----|---------------|
| | YES | NO | DON'T KNOW |
| BASE: | ----- | | |
| Your Chamber | 135 | 26% | 6% |
| Your State | 721 | 19% | 6% |
| New England | 8216 | 16% | 7% |

Question 4: Do you think that now is a good time to buy ... a home, a car, commercial real estate?

| | ===== | | | |
|--------------|-------|-----|---------------------------|----------------------|
| | HOME | CAR | COMMERCIAL REAL ESTATE | NONE OF THE ABOVE |
| BASE: | ----- | | | |
| Your Chamber | 134 | 80% | 53% | 13% |
| Your State | 714 | 83% | 53% | 12% |
| New England | 8160 | 82% | 53% | 13% |

New England Chamber of Commerce 1991 Economic Study

[GREATER MANCHESTER] CHAMBER OF COMMERCE

ECONOMIC OUTLOOK

Question 5: Do you feel that your company is in a better position financially, no different, or in a worse position financially than it was a year ago?

| | ===== | | |
|--------------|----------|-----------|----------|
| | BETTER | NO | WORSE |
| BASE: | POSITION | DIFFERENT | POSITION |
| | ----- | | |
| Your Chamber | 134 | 28% | 36% |
| Your State | 718 | 28% | 30% |
| New England | 8187 | 23% | 28% |
| | | | 37% |
| | | | 42% |
| | | | 49% |

Question 6: Does your company plan on expanding its physical plant or making any significant capital expenditures in the next two years?

Question 7: In the last six months, has your company cancelled or postponed any significant capital expenditures due to the continued downturn in the economy?

| | ===== | | | ===== | | | |
|--------------|-------|-----|-----|-------|-----|---------------|----|
| | q6 | | | q7 | | | |
| BASE: | YES | NO | | YES | NO | DON'T KNOW | |
| | ----- | | | ----- | | | |
| Your Chamber | 135 | 28% | 72% | 135 | 49% | 50% | 1% |
| Your State | 718 | 26% | 74% | 722 | 47% | 50% | 3% |
| New England | 8193 | 24% | 76% | 8215 | 50% | 46% | 3% |

Question 8: From a business perspective, please compare the current recession to other economic downturns you have experienced.

| | ===== | | | | |
|--------------|-------|------|-----------------------|---------------|-----|
| BASE: | WORST | SAME | MILDER THAN OTHERS | DON'T KNOW | |
| | ----- | | | | |
| Your Chamber | 135 | 74% | 10% | 3% | 13% |
| Your State | 720 | 70% | 13% | 3% | 14% |
| New England | 8212 | 69% | 14% | 4% | 13% |

New England Chamber of Commerce 1991 Economic Study

[GREATER MANCHESTER] CHAMBER OF COMMERCE

CREDIT & FINANCE

Question 1: Much has been written about the "New England credit crunch." Has your business actually experienced tightened lending standards to the point where you believe credit was unjustly denied?

| | ===== | | |
|--------------|-------|-----|-----|
| | BASE: | YES | NO |
| | ----- | | |
| Your Chamber | 130 | 43% | 57% |
| Your State | 695 | 41% | 59% |
| New England | 7869 | 39% | 61% |

Question 2: In general, do you feel it has become more difficult, somewhat more difficult or not difficult at all for your business to obtain a commercial loan?

| | ===== | | | |
|--------------|-----------------|-----------|--------|---------------|
| | MUCH MORE | SOMEWHAT | MORE | NOT DIFFICULT |
| | BASE: DIFFICULT | DIFFICULT | AT ALL | |
| | ----- | | | |
| Your Chamber | 123 | 47% | 44% | 9% |
| Your State | 649 | 47% | 42% | 12% |
| New England | 7401 | 44% | 42% | 14% |

New England Chamber of Commerce 1991 Economic Study

[GREATER MANCHESTER] CHAMBER OF COMMERCE

NEW ENGLAND'S COMPETITIVENESS QUOTIENT

Question 1: Corporate executives and site selection consultants evaluate a host of issues when looking for the ideal place to situate a business. Please indicate how you feel your State rates in the following areas, and how you feel New England as a whole compares with other regions of the country.

| | RESULTS FOR YOUR CHAMBER | | | | | | | | | | | | | |
|--------------------------------------|--------------------------|--------------|-------------|-------------|-------------|-------------|-------------|------|--------------|-------------|-------------|-------------|-------------|------|
| | Your State | | | | | | New England | | | | | | | |
| | BASE | EXC/ GOOD | EXC. (4) | GOOD (3) | FAIR (2) | POOR (1) | MEAN | BASE | EXC/ GOOD | EXC. (4) | GOOD (3) | FAIR (2) | POOR (1) | MEAN |
| WORKFORCE ISSUES | | | | | | | | | | | | | | |
| Availability of skilled labor | 130 | 88% | 42% | 45% | 12% | 1% | 3.29 | 114 | 94% | 52% | 42% | 6% | - | 3.46 |
| Availability of unskilled labor | 128 | 86% | 41% | 45% | 13% | 1% | 3.26 | 113 | 87% | 35% | 51% | 12% | 2% | 3.20 |
| Labor costs | 123 | 48% | 10% | 38% | 45% | 7% | 2.50 | 108 | 41% | 5% | 36% | 48% | 11% | 2.34 |
| Union atmosphere | 116 | 58% | 16% | 41% | 25% | 17% | 2.57 | 104 | 38% | 3% | 35% | 51% | 12% | 2.29 |
| INFRASTRUCTURE NEEDS | | | | | | | | | | | | | | |
| Telecommunication services | 118 | 86% | 42% | 44% | 12% | 2% | 3.27 | 104 | 95% | 46% | 49% | 5% | - | 3.41 |
| Highway accessibility | 127 | 88% | 34% | 54% | 9% | 2% | 3.20 | 109 | 92% | 33% | 59% | 8% | - | 3.25 |
| Railroad service | 119 | 20% | 6% | 14% | 23% | 57% | 1.69 | 106 | 47% | 8% | 40% | 32% | 21% | 2.34 |
| Airport service | 128 | 67% | 23% | 45% | 27% | 6% | 2.84 | 111 | 82% | 32% | 50% | 15% | 3% | 3.11 |
| Port accessibility | 117 | 44% | 8% | 36% | 38% | 18% | 2.33 | 104 | 77% | 20% | 57% | 19% | 4% | 2.93 |
| Technology concentration | 116 | 67% | 17% | 50% | 27% | 6% | 2.78 | 105 | 92% | 47% | 46% | 5% | 3% | 3.36 |
| PUBLIC POLICY ISSUES | | | | | | | | | | | | | | |
| Government tax incentives | 120 | 23% | 6% | 18% | 41% | 36% | 1.93 | 99 | 17% | 2% | 15% | 58% | 25% | 1.94 |
| Attitude toward business community | 124 | 54% | 12% | 42% | 34% | 12% | 2.54 | 105 | 41% | 3% | 38% | 50% | 9% | 2.35 |
| Environmental regulation | 122 | 54% | 6% | 48% | 37% | 9% | 2.51 | 103 | 46% | 4% | 42% | 43% | 12% | 2.38 |
| Corporate tax structure | 123 | 33% | 4% | 29% | 41% | 25% | 2.12 | 102 | 22% | 1% | 21% | 63% | 16% | 2.07 |
| FINANCIAL | | | | | | | | | | | | | | |
| Availability of long term financing | 112 | 13% | - | 13% | 40% | 46% | 1.67 | 97 | 15% | 1% | 14% | 51% | 34% | 1.82 |
| Access to working capital | 114 | 11% | - | 11% | 42% | 47% | 1.63 | 98 | 8% | 1% | 7% | 54% | 38% | 1.71 |
| Housing costs | 126 | 33% | 5% | 29% | 44% | 23% | 2.15 | 105 | 22% | 5% | 17% | 52% | 26% | 2.01 |
| Workers compensation costs | 124 | 19% | 1% | 18% | 48% | 34% | 1.85 | 103 | 17% | 1% | 16% | 47% | 37% | 1.81 |
| Health care costs | 126 | 6% | - | 6% | 45% | 48% | 1.58 | 104 | 4% | 1% | 3% | 40% | 56% | 1.49 |
| Commercial/industrial property costs | 123 | 40% | 7% | 33% | 43% | 17% | 2.30 | 104 | 29% | 5% | 24% | 56% | 15% | 2.18 |
| Overall cost of living | 127 | 35% | 3% | 32% | 46% | 18% | 2.20 | 107 | 12% | 3% | 9% | 64% | 23% | 1.92 |
| Energy costs | 121 | 10% | 1% | 9% | 50% | 40% | 1.70 | 102 | 8% | - | 8% | 64% | 28% | 1.79 |
| QUALITY OF LIFE ISSUES | | | | | | | | | | | | | | |
| Crime | 124 | 70% | 18% | 52% | 23% | 7% | 2.81 | 105 | 31% | 3% | 29% | 50% | 19% | 2.15 |
| Health care accessibility | 129 | 78% | 24% | 54% | 19% | 3% | 2.99 | 110 | 76% | 34% | 43% | 19% | 5% | 3.05 |
| Public school facilities | 129 | 67% | 13% | 54% | 25% | 8% | 2.73 | 110 | 66% | 8% | 58% | 28% | 5% | 2.69 |
| Higher education facilities | 129 | 78% | 23% | 55% | 21% | 1% | 3.01 | 110 | 95% | 56% | 39% | 5% | - | 3.52 |
| Cultural opportunities | 129 | 66% | 11% | 55% | 25% | 9% | 2.67 | 110 | 94% | 51% | 43% | 5% | 2% | 3.43 |

New England Chamber of Commerce 1991 Economic Study

[GREATER MANCHESTER] CHAMBER OF COMMERCE

NEW ENGLAND'S COMPETITIVENESS QUOTIENT

Question 1: Corporate executives and site selection consultants evaluate a host of issues when looking for the ideal place to situate a business. Please indicate how you feel your State rates in the following areas, and how you feel New England as a whole compares with other regions of the country.

| | RESULTS FOR YOUR STATE | | | | | | | | | | | | | |
|--------------------------------------|------------------------|--------------|-------------|-------------|-------------|-------------|-------------|------|--------------|-------------|-------------|-------------|-------------|------|
| | Your State | | | | | | New England | | | | | | | |
| | BASE | EXC/ GOOD | EXC. (4) | GOOD (3) | FAIR (2) | POOR (1) | MEAN | BASE | EXC/ GOOD | EXC. (4) | GOOD (3) | FAIR (2) | POOR (1) | MEAN |
| WORKFORCE ISSUES | | | | | | | | | | | | | | |
| Availability of skilled labor | 690 | 84% | 35% | 49% | 14% | 2% | 3.17 | 599 | 90% | 43% | 47% | 9% | 2% | 3.31 |
| Availability of unskilled labor | 677 | 84% | 36% | 49% | 14% | 2% | 3.19 | 588 | 83% | 31% | 52% | 15% | 2% | 3.13 |
| Labor costs | 677 | 52% | 9% | 43% | 39% | 9% | 2.52 | 586 | 39% | 4% | 35% | 47% | 13% | 2.30 |
| Union atmosphere | 598 | 49% | 14% | 35% | 35% | 16% | 2.47 | 532 | 36% | 5% | 31% | 48% | 15% | 2.27 |
| INFRASTRUCTURE NEEDS | | | | | | | | | | | | | | |
| Telecommunication services | 624 | 85% | 31% | 54% | 13% | 3% | 3.13 | 538 | 93% | 37% | 56% | 7% | 1% | 3.29 |
| Highway accessibility | 674 | 77% | 30% | 48% | 17% | 5% | 3.02 | 576 | 88% | 30% | 58% | 11% | 2% | 3.16 |
| Railroad service | 640 | 18% | 4% | 14% | 32% | 50% | 1.72 | 559 | 40% | 6% | 34% | 39% | 21% | 2.26 |
| Airport service | 671 | 42% | 10% | 31% | 38% | 20% | 2.32 | 573 | 76% | 20% | 56% | 21% | 3% | 2.92 |
| Port accessibility | 636 | 49% | 13% | 37% | 34% | 16% | 2.46 | 555 | 72% | 19% | 53% | 24% | 4% | 2.86 |
| Technology concentration | 610 | 59% | 12% | 47% | 32% | 10% | 2.60 | 536 | 87% | 34% | 53% | 10% | 3% | 3.19 |
| PUBLIC POLICY ISSUES | | | | | | | | | | | | | | |
| Government tax incentives | 636 | 22% | 4% | 19% | 39% | 39% | 1.88 | 529 | 22% | 2% | 20% | 51% | 27% | 1.98 |
| Attitude toward business community | 661 | 45% | 9% | 36% | 37% | 18% | 2.37 | 551 | 40% | 2% | 38% | 45% | 15% | 2.28 |
| Environmental regulation | 654 | 46% | 4% | 42% | 38% | 15% | 2.35 | 543 | 43% | 1% | 42% | 42% | 15% | 2.30 |
| Corporate tax structure | 633 | 27% | 3% | 24% | 41% | 33% | 1.97 | 529 | 24% | 1% | 23% | 57% | 19% | 2.05 |
| FINANCIAL | | | | | | | | | | | | | | |
| Availability of long term financing | 614 | 19% | - | 19% | 43% | 38% | 1.81 | 507 | 21% | - | 21% | 49% | 30% | 1.91 |
| Access to working capital | 609 | 18% | - | 18% | 44% | 38% | 1.80 | 500 | 19% | 1% | 19% | 50% | 31% | 1.89 |
| Housing costs | 667 | 32% | 5% | 27% | 44% | 24% | 2.14 | 543 | 24% | 3% | 22% | 48% | 28% | 2.00 |
| Workers compensation costs | 653 | 16% | 1% | 15% | 45% | 39% | 1.78 | 526 | 12% | 1% | 12% | 49% | 38% | 1.75 |
| Health care costs | 665 | 9% | - | 9% | 37% | 54% | 1.55 | 536 | 9% | - | 9% | 38% | 54% | 1.55 |
| Commercial/industrial property costs | 643 | 34% | 5% | 28% | 43% | 24% | 2.15 | 527 | 25% | 3% | 23% | 50% | 24% | 2.04 |
| Overall cost of living | 665 | 35% | 3% | 32% | 45% | 20% | 2.18 | 545 | 17% | 1% | 17% | 57% | 26% | 1.92 |
| Energy costs | 646 | 17% | 1% | 15% | 45% | 39% | 1.79 | 531 | 17% | - | 17% | 52% | 31% | 1.86 |
| QUALITY OF LIFE ISSUES | | | | | | | | | | | | | | |
| Crime | 660 | 76% | 23% | 53% | 19% | 5% | 2.94 | 550 | 32% | 3% | 29% | 49% | 19% | 2.16 |
| Health care accessibility | 680 | 74% | 21% | 53% | 22% | 4% | 2.91 | 566 | 76% | 30% | 45% | 20% | 4% | 3.01 |
| Public school facilities | 681 | 68% | 14% | 54% | 25% | 7% | 2.75 | 567 | 63% | 10% | 54% | 32% | 5% | 2.68 |
| Higher education facilities | 682 | 76% | 26% | 51% | 20% | 3% | 2.99 | 569 | 93% | 55% | 37% | 6% | 1% | 3.47 |
| Cultural opportunities | 672 | 60% | 15% | 44% | 32% | 8% | 2.67 | 563 | 92% | 46% | 46% | 7% | 2% | 3.36 |

New England Chamber of Commerce 1991 Economic Study

[GREATER MANCHESTER] CHAMBER OF COMMERCE

NEW ENGLAND'S COMPETITIVENESS QUOTIENT

Question 1: Corporate executives and site selection consultants evaluate a host of issues when looking for the ideal place to situate a business. Please indicate how you feel your State rates in the following areas, and how you feel New England as a whole compares with other regions of the country.

| | RESULTS FOR NEW ENGLAND | | | | | | | | | | | | | |
|--------------------------------------|-------------------------|--------------|-------------|-------------|-------------|-------------|------|-------------|--------------|-------------|-------------|-------------|-------------|------|
| | Your State | | | | | | | New England | | | | | | |
| | BASE | EXC/ GOOD | EXC. (4) | GOOD (3) | FAIR (2) | POOR (1) | MEAN | BASE | EXC/ GOOD | EXC. (4) | GOOD (3) | FAIR (2) | POOR (1) | MEAN |
| WORKFORCE ISSUES | | | | | | | | | | | | | | |
| Availability of skilled labor | 7783 | 79% | 34% | 45% | 17% | 4% | 3.09 | 6514 | 86% | 32% | 54% | 12% | 2% | 3.17 |
| Availability of unskilled labor | 7624 | 82% | 31% | 51% | 16% | 2% | 3.10 | 6376 | 82% | 26% | 56% | 16% | 2% | 3.06 |
| Labor costs | 7583 | 28% | 4% | 24% | 44% | 27% | 2.05 | 6303 | 30% | 3% | 27% | 51% | 19% | 2.14 |
| Union atmosphere | 6877 | 23% | 4% | 18% | 43% | 35% | 1.92 | 5817 | 24% | 2% | 21% | 49% | 27% | 2.00 |
| INFRASTRUCTURE NEEDS | | | | | | | | | | | | | | |
| Telecommunication services | 7225 | 88% | 37% | 51% | 10% | 2% | 3.23 | 5918 | 91% | 34% | 57% | 8% | 1% | 3.24 |
| Highway accessibility | 7646 | 79% | 31% | 48% | 16% | 5% | 3.06 | 6197 | 85% | 26% | 58% | 13% | 2% | 3.09 |
| Railroad service | 7278 | 38% | 9% | 29% | 35% | 27% | 2.19 | 5953 | 46% | 8% | 38% | 38% | 16% | 2.37 |
| Airport service | 7567 | 61% | 15% | 45% | 29% | 10% | 2.66 | 6135 | 67% | 14% | 53% | 28% | 5% | 2.75 |
| Port accessibility | 6934 | 60% | 17% | 43% | 27% | 13% | 2.63 | 5763 | 67% | 14% | 53% | 28% | 5% | 2.76 |
| Technology concentration | 6923 | 68% | 27% | 41% | 24% | 8% | 2.88 | 5730 | 82% | 26% | 56% | 15% | 3% | 3.05 |
| PUBLIC POLICY ISSUES | | | | | | | | | | | | | | |
| Government tax incentives | 7221 | 8% | 1% | 7% | 33% | 59% | 1.50 | 5659 | 17% | 1% | 16% | 47% | 36% | 1.81 |
| Attitude toward business community | 7552 | 18% | 2% | 16% | 38% | 43% | 1.76 | 5852 | 28% | 1% | 27% | 48% | 24% | 2.06 |
| Environmental regulation | 7449 | 29% | 3% | 26% | 40% | 30% | 2.02 | 5803 | 32% | 2% | 30% | 47% | 20% | 2.14 |
| Corporate tax structure | 7213 | 11% | 1% | 10% | 44% | 46% | 1.65 | 5608 | 18% | 1% | 17% | 54% | 29% | 1.90 |
| FINANCIAL | | | | | | | | | | | | | | |
| Availability of long term financing | 7020 | 18% | 1% | 17% | 45% | 36% | 1.83 | 5392 | 21% | 1% | 20% | 49% | 30% | 1.92 |
| Access to working capital | 6888 | 17% | 1% | 16% | 46% | 37% | 1.81 | 5288 | 21% | 1% | 20% | 49% | 30% | 1.92 |
| Housing costs | 7557 | 19% | 2% | 17% | 41% | 40% | 1.82 | 5735 | 23% | 2% | 21% | 49% | 28% | 1.96 |
| Workers compensation costs | 7509 | 6% | 1% | 5% | 22% | 73% | 1.34 | 5652 | 10% | - | 9% | 41% | 49% | 1.61 |
| Health care costs | 7578 | 4% | - | 4% | 22% | 74% | 1.30 | 5717 | 7% | - | 7% | 34% | 59% | 1.48 |
| Commercial/industrial property costs | 7409 | 20% | 2% | 18% | 48% | 32% | 1.90 | 5635 | 24% | 2% | 22% | 51% | 25% | 2.01 |
| Overall cost of living | 7583 | 13% | 1% | 12% | 46% | 41% | 1.73 | 5735 | 17% | 1% | 16% | 52% | 31% | 1.87 |
| Energy costs | 7357 | 10% | 1% | 10% | 45% | 45% | 1.66 | 5603 | 15% | 1% | 14% | 49% | 36% | 1.80 |
| QUALITY OF LIFE ISSUES | | | | | | | | | | | | | | |
| Crime | 7501 | 38% | 8% | 30% | 38% | 23% | 2.24 | 5835 | 40% | 3% | 36% | 44% | 16% | 2.26 |
| Health care accessibility | 7704 | 72% | 25% | 47% | 21% | 7% | 2.90 | 5931 | 72% | 19% | 53% | 22% | 6% | 2.85 |
| Public school facilities | 7693 | 57% | 11% | 46% | 32% | 11% | 2.57 | 5917 | 59% | 8% | 51% | 34% | 7% | 2.60 |
| Higher education facilities | 7705 | 82% | 41% | 41% | 14% | 4% | 3.19 | 5965 | 88% | 42% | 46% | 10% | 2% | 3.28 |
| Cultural opportunities | 7645 | 75% | 33% | 41% | 20% | 5% | 3.03 | 5923 | 85% | 35% | 50% | 12% | 2% | 3.18 |

New England Chamber of Commerce 1991 Economic Study

[GREATER MANCHESTER] CHAMBER OF COMMERCE

NEW ENGLAND'S COMPETITIVENESS QUOTIENT

Question 2: Compared with other regions of the country, do you feel New England is a good place to locate a business?

| | ===== | |
|--------------|-----------|---------|
| | BASE: YES | NO |
| | ----- | |
| Your Chamber | 132 | 75% 25% |
| Your State | 696 | 75% 25% |
| New England | 7973 | 46% 54% |

Question 3: How would you rate your State's business climate?

| | ===== | | | | | |
|--------------|--------------|--------------|---------|----------|------------|-----|
| | VERY | MODERATELY | NEUTRAL | ANTI- | VERY ANTI- | |
| | PRO-BUSINESS | PRO-BUSINESS | | BUSINESS | BUSINESS | |
| | ----- | | | | | |
| Your Chamber | 132 | 20% | 62% | 13% | 3% | 2% |
| Your State | 702 | 17% | 53% | 20% | 9% | 1% |
| New England | 8100 | 5% | 29% | 24% | 31% | 11% |

Question 4: Has your company ever considered relocating outside New England?

| | ===== | | | | |
|--------------|------------|----------|------------|-----------------|----|
| | SERIOUSLY | GIVEN IT | NEVER | HAVE ALREADY | |
| | CONSIDERED | PASSING | CONSIDERED | RELOCATED PARTS | |
| | ----- | | | | |
| Your Chamber | 132 | 5% | 17% | 73% | 5% |
| Your State | 692 | 6% | 17% | 72% | 5% |
| New England | 7833 | 12% | 23% | 60% | 5% |

New England Chamber of Commerce 1991 Economic Study

[GREATER MANCHESTER] CHAMBER OF COMMERCE

NEW ENGLAND'S COMPETITIVENESS QUOTIENT

Question 5: If your company has considered relocating outside New England, what is the principal reason why?

| | YOUR CHAMBER | YOUR STATE | NEW ENGLAND |
|--|-----------------|---------------|----------------|
| BASE: | 21 | 114 | 2245 |
| High Tax Structure | 19% | 18% | 29% |
| Poor Government Attitude/Antibusiness | 5% | 7% | 16% |
| Business Costs | 5% | 4% | 15% |
| Workmen's Compensation Costs | 5% | 4% | 14% |
| Cost of Living | 10% | 9% | 14% |
| Labor Costs | 19% | 10% | 11% |
| Poor Economy | 24% | 16% | 9% |
| Poor Business Climate | 5% | 10% | 9% |
| No progress/Lack of Opportunities | 14% | 9% | 9% |
| Health Care Cost | - | 4% | 6% |
| High Utilities/Energy Costs | 10% | 7% | 5% |
| High Insurance | - | - | 5% |
| Commercial Property Costs/Real Estate Costs | 5% | 7% | 4% |
| Regulation Problems | - | 1% | 4% |
| Seasonal Relocation/Move to Southern States | - | 11% | 3% |
| Lack of skilled labor/Poor employee attitude | 10% | 4% | 2% |
| Expansion | - | 6% | 2% |
| Banking Crisis/Lack of Credit | - | 4% | 2% |
| Low profits | - | 3% | 2% |
| Climate/Weather | - | 4% | 2% |
| Poor Environment | - | 2% | 1% |
| Union Dominance | 10% | 2% | 1% |
| Overcrowding/High Crime | - | 1% | 1% |
| Personal Reasons | - | - | 1% |
| Poor credit for small companies | - | - | - |
| Transportation | - | 1% | - |
| Education | - | 1% | - |
| Other | 14% | 8% | 7% |
| None | - | - | - |

New England Chamber of Commerce 1991 Economic Study

[GREATER MANCHESTER] CHAMBER OF COMMERCE

REGIONAL COOPERATION

Question 1: From a business perspective, what is New England's principal strength?

| | ===== | ===== | ===== |
|--|-----------------|---------------|----------------|
| | YOUR CHAMBER | YOUR STATE | NEW ENGLAND |
| | ----- | ----- | ----- |
| BASE: | 113 | 566 | 6287 |
| Diverse workforce | | | |
| skilled labor | 46% | 38% | 36% |
| Quality of Education | 24% | 14% | 20% |
| Quality of life | | | |
| Standard of Living | 13% | 20% | 13% |
| Location | | | |
| Accessibility to ports | 6% | 11% | 12% |
| People | | | |
| Resources | | | |
| Infrastructure | 14% | 11% | 12% |
| High technology belt | 4% | 7% | 11% |
| Geographic attributes (Climate, scenic beauty, seasons) | 4% | 8% | 8% |
| Population Density | | | |
| Large Market | 8% | 5% | 6% |
| Work Ethics | | | |
| Yankee Ingenuity | 10% | 11% | 5% |
| Culture | | | |
| History | 3% | 2% | 4% |
| Tourism | 2% | 3% | 2% |
| Transportation | 2% | 2% | 2% |
| Health Care | | | |
| Hospital Services | | 1% | 2% |
| High Per Capita Income/Disposable Income | - | - | - |
| Job Market | | | |
| Available work | - | - | - |
| Other | 4% | 4% | 3% |
| Don't Know | 1% | 1% | 1% |
| None | - | 1% | 1% |

New England Chamber of Commerce 1991 Economic Study

[GREATER MANCHESTER] CHAMBER OF COMMERCE

REGIONAL COOPERATION

Question 1: From a business perspective, what is New England's principal weakness?

| | YOUR CHAMBER | YOUR STATE | NEW ENGLAND |
|--|-----------------|---------------|----------------|
| BASE: | 106 | 549 | 6418 |
| High cost of living/high energy costs | 26% | 25% | 23% |
| Corrupt government | | | |
| Govt Anti Business politics. | | | |
| High taxes | 6% | 11% | 21% |
| Cost of business | 13% | 14% | 20% |
| Business climate/Poor economy/ | 3% | 6% | 10% |
| Recession/Unemployment | | | |
| High workers compensation rates | 9% | 10% | 9% |
| Union environment | | | |
| Financial condition (loans, banking, bankruptcy) | 4% | 2% | 9% |
| High Cost of Labor | 27% | 17% | 8% |
| Anti-Business (n-s) | 8% | 4% | 5% |
| Anti Business attitude of residents | | | |
| Real estate costs | 2% | 2% | 4% |
| Infrastructure | 7% | 6% | 3% |
| Few specialized industries/No Diversity | | | |
| Regulatory problems | 2% | 2% | 3% |
| Location | - | 1% | 3% |
| Lack of resources | | | |
| Healthcare costs | 4% | 4% | 3% |
| Transportation | 1% | 1% | 2% |
| Weak Manufacturing | 4% | 4% | 2% |
| No manufact. | | | |
| Climate | 3% | 2% | 2% |
| weather | | | |
| No skilled Labor | 4% | 5% | 2% |
| bad attitudes | | | |
| Parochialism | 1% | 1% | 2% |
| Provincialism | | | |
| High % of welfare programs | - | 2% | 2% |
| Too Liberal | - | 1% | 1% |
| Quality of education | - | 1% | 1% |
| Defence concentration | - | 1% | 1% |
| Govt resources channeled into defence | | | |
| Crime/drugs | - | 1% | 1% |
| Legal Climate | - | - | 1% |
| Excessive gov't spending | 1% | - | - |
| Demographics | | | |
| Other | - | - | - |
| None | 5% | 6% | 4% |
| Don't know | 1% | 1% | 1% |

RACE

The Washington Post

C. Boyden Gray

THURSDAY, NOVEMBER 14, 1991

Civil Rights: We Won, They Capitulated

Contrary to a rapidly congealing press myth, President Bush did not "cave" or "surrender" on quotas in the new civil rights bill. Nor were any of the president's actions taken in response to the Clarence Thomas hearings or the David Duke campaign. On the contrary, the compromise bill the president will sign became possible only after the Democrats beat a total retreat on quotas, thereby paving the way for the president to make concessions on other, less fundamental, issues.

To understand what happened, the public needs to know the story of an extraordinary amendment that was adopted without debate or a vote. But first we must set the stage.

Under the Supreme Court's 1971 *Griggs* decision, employment practices having an adverse statistical impact on certain groups can lead to liability even if there was no hint of discriminatory intent. In 1989, the *Wards Cove* case summarized the rules under which such lawsuits would be conducted, noting that unfair rules would drive employers to use quotas to avoid any possibility of being dragged into such a lawsuit.

For the past two years, Democrats have insisted that *Wards Cove* overruled *Griggs* and that legislation was needed to "restore" pre-*Wards Cove* law. The changes they actually proposed, however, would have gone much further, exposing countless employers to ruinous litigation and liability any time their numbers were not "right."

Administration lawyers always believed that the Supreme Court was right to think that *Griggs* and *Wards Cove* were consistent with each other. More important, we knew that the Democrats' "restoration" was in fact a radical and destructive distortion of prior legal doctrine. If "bad numbers" alone became a sufficient basis for legal liability, employers would be foolish not to use quotas.

Last March, the president proposed a bill that made a symbolically important but practically insignificant concession to the Democrats on one issue involving the burden of proof. In other respects, the president's bill codified the law as it existed prior to *Wards Cove* (and which we believed was fully consistent with that decision). The Democrats in Congress never gave this bill the time of day.

Suddenly, on Thursday, Oct. 24, Sen. Edward Kennedy stunned administration negotiators by agreeing to a *Wards Cove* proposal developed by

Sen. Robert Dole and transmitted through Sen. John Danforth. This option was virtually identical in substance to the president's bill and to other formulations that Kennedy and the private lobbyists for his bill had rejected time and again.

On most issues, the Dole proposal used language drawn from the president's bill and the analytical memorandum that accompanied the bill. On the contentious issue of "business necessity," which defines the standard that employers must meet in justifying statistical disparities, the proposal used essentially meaningless language from the Americans With Disabilities Act that left the term in question *undefined*. (Ironically, the negotiators of the disability law had settled on this empty lan-

"The president won a clean victory for equal opportunity, and that victory will survive the current round of fictions."

guage because they expected the issue to be addressed and resolved in the context of the upcoming civil rights bill.)

In its most critical component, the Dole proposal included *exclusive legislative history* that would supply the definition of "business necessity" by referencing the case law as it stood immediately prior to the *Wards Cove* decision. In two carefully negotiated explanatory sentences, the proposal indirectly accomplished what the president's bill had done in so many words: codifying the law of disparate impact as it stood at the time of *Wards Cove* (except on the burden of proof). Because the statutory language provided no definition, the definition referenced in the legislative history would necessarily be dispositive in the courts; for that reason, 90 percent of the negotiations centered on the legislative history rather than on the statute itself.

In return for Sen. Kennedy's complete capitulation on quotas, the administration agreed to several compromises proposed by Sen. Danforth on other issues. The question on which the administration was most reluctant was the application of jury trials and punitive damages to employment cases under the Civil Rights Act. Although the Danforth proposal includes caps on such awards, thereby setting an important precedent for tort reform, such remedies are undeniably a dangerous experiment (as is suggested by the senators' 54-42 vote *against* a proposal to apply to themselves the same remedies they are imposing on the private sector).

Despite our strong misgivings about jury trials and damages, the agreement was sealed, and our startling success on *Wards Cove* remained the most salient component of the package. Imagine, then, how disturbed we were to learn that Sen. Kennedy went to the floor of the Senate the very next day to create legislative history, inconsistent with Thursday night's agreement, attempting to resuscitate one of the most radically objectionable features of the original Democratic bill. Had we been sandbagged? Had the agreement so laboriously negotiated ever been meant to stick?

The following Monday, the administration proposed an innovative statutory provisions specially designed to enforce the Thursday night agreement. This provision directed the courts to ignore any legislative history (such as the description of the agreement given by Kennedy on Friday) apart from the two sentences originally agreed to. Sens. Kennedy and Danforth objected to this proposal, while administration negotiators felt they had to insist. Tense meetings ensued, and it seemed at points that there might be no civil rights bill after all.

On Tuesday, Sens. Dole and Orrin Hatch engaged in heroic efforts to hold Sen. Kennedy and his allies to the agreement. Republican Leader Dole's arguments were particularly effective—that night, without any debate or a recorded vote, the Senate accepted a slightly modified version of the administration proposal enforcing the deal.

Heroic efforts to enforce the agreement would not have been required unless there had been something very significant were at stake. And there was. Buried in this dispute, as in earlier arcane debates over legal terminology, was the difference between preserving the essence of current law and creating a new quota monster. It also meant the difference between a system that will encourage kids to stay in school and a novel system of legal threats against those who reward hard work and achievement. On these fundamental issues the president won a clean victory for equal opportunity, and that victory will survive the current round of fictions about some supposed political surrender.

The writer is counsel to the president.

The Pan Am bombers

A confession in the Congo and matching pieces of two bombs point an accusing finger at Libya

Apollinaire Mangatany was a careful man but also a greedy one. On the morning of Sept. 18, 1989, less than 24 hours before he was to board an airplane at the Maya Maya Airport in Brazzaville, the capital of the People's Republic of the Congo, Mangatany stopped in for a visit with the local juju priest. The trip would be a dangerous one, the African psychic told Mangatany; he should find a reason to cancel it. Mangatany knew all about the danger. After all, he had agreed to carry a bomb aboard the plane and blow it up when the aircraft stopped to pick up more passengers in Chad.

Mangatany had a 5-year-old son and a pregnant common-law wife. He had no job. But if he blew up the plane, a spy for the government of Muammar Qadhafi would pay him a meager sum. The spy, a man named Abdalla Elazrag, had assured him that everything would be all right. He had even given Mangatany a red necktie. Once he had deposited the bomb on the aircraft and left the plane in Chad, Elazrag promised Mangatany, another Libyan spy would recognize the red tie and spirit Mangatany out of the airport to safety. Apollinaire Mangatany thought about the words of the juju man, thought about the money promised by the spy, then boarded the airplane with the bomb. Not long after takeoff, it blew up, killing Mangatany and 170 other people.

From this improbable beginning, the investigators who have spent nearly

three years pursuing those responsible for the worst terrorist attack in U.S. history, the destruction of Pan Am Flight 103 over the village of Lockerbie, Scotland, have fashioned the first two criminal indictments in the inquiry. Stemming as they do from the most far-reaching and complex criminal investigation in history, the charges against two midlevel officials of the Libyan government seem embarrassingly modest. But they are the

first fruits of a dramatic turn in the investigation, and they pose a host of new questions for the Bush administration and for America's on-again, off-again battles against terrorism and against Libya's Qadhafi (box, Page 26).

For most of the first two years after the Pan Am Clipper Maid of the Seas shattered over Lockerbie, killing all 259 passengers and 11 more people on the ground, investigators from the FBI and the Scottish police focused on a Palestinian terrorist group operating in the heart of Europe. The evidence seemed compelling. Less than a month before Flight 103 was destroyed, on Dec. 21, 1988, federal police in Germany had arrested 14 known and suspected terrorists and seized a sophisticated

ed bomb designed especially for the destruction of an airplane.

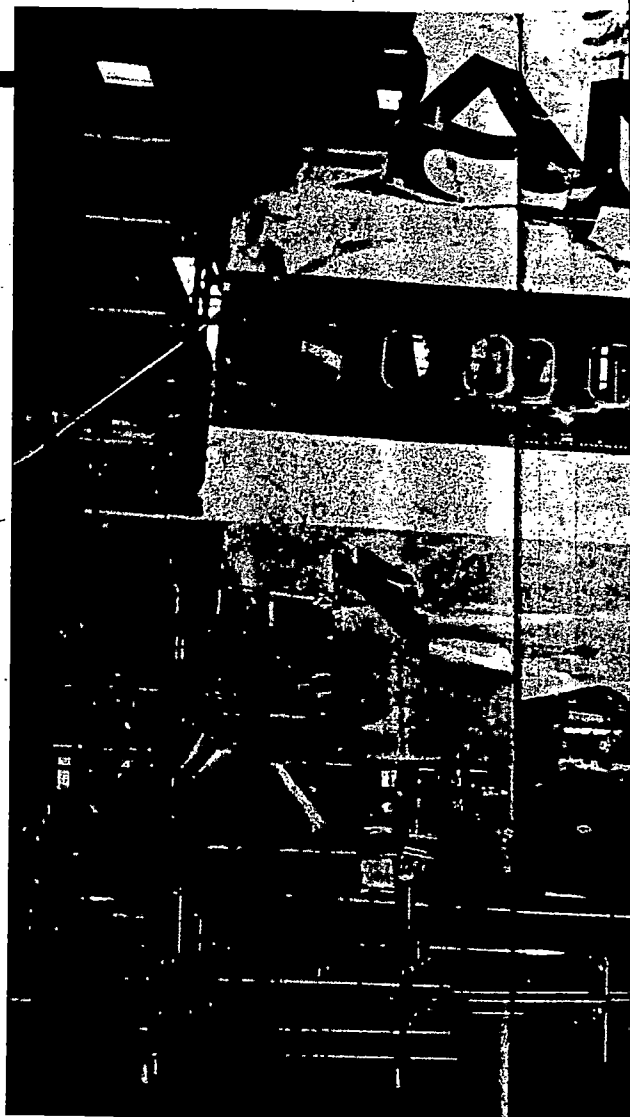
That evidence and more pointed to the Popular Front for the Liberation of Palestine-General Command. Its leader was an excitable little man with a paunch named Ahmed Jibril. Its patron was Syria. And its banker for the attack



Megrahi. A French connection

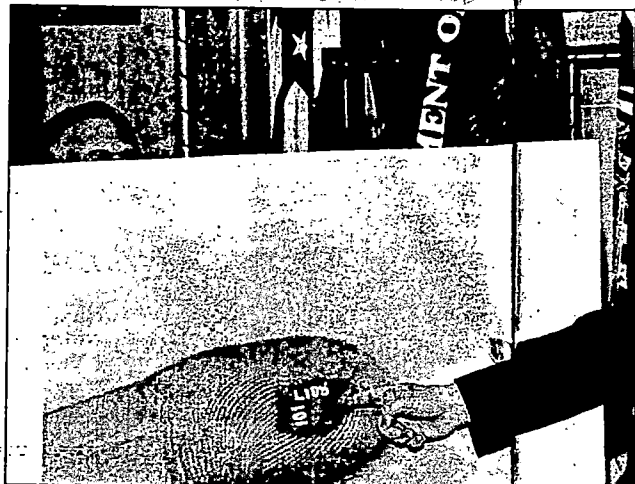


Khalifa. Traced to the isle of Malta



Evidence. A meticulous reconstruction of the

Maid of the

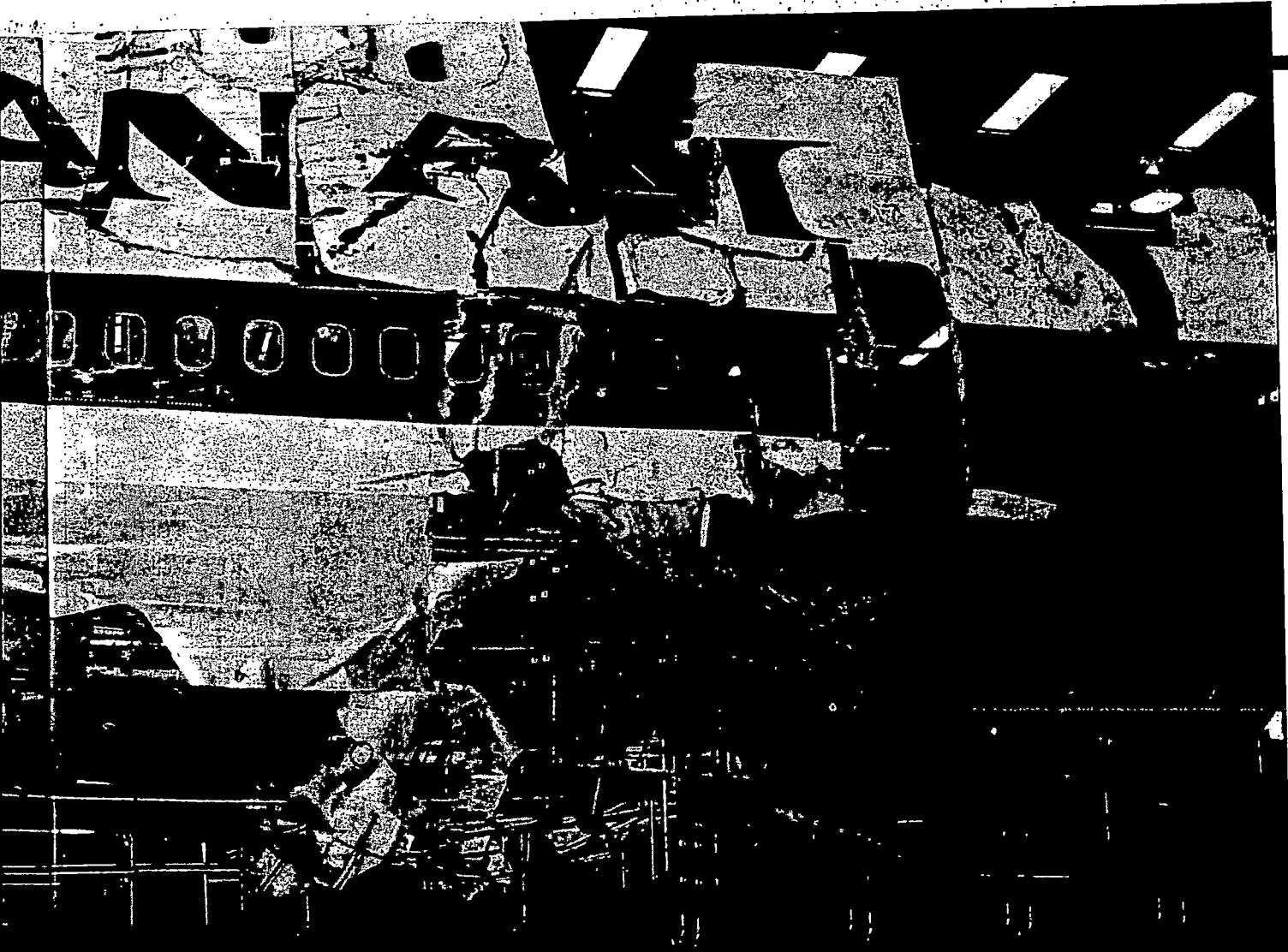


Success. Acting Attorney General William Barr

unveiling t

on the American aircraft appeared to be Iran: U.S. intelligence officials traced a wire transfer of several million dollars from Tehran to a bank account in Vienna controlled by the PFLP-GC. Iran's motive, too, seemed compelling enough. On July 3, 1988, the USS Vincennes had mistakenly shot down an

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Maid of the Seas allowed investigators to link the bombing to an attack on a French airliner in Africa.



BARRY THUMMA—AP

Barr unveiling the grand jury indictments

jet belonged to a French firm, Union des Transports Aériennes. Because the flight had departed from the Congo, French authorities began collaborating with Congolese government investigators.

It was the Congolese who got the first big break in the case. According to a secret report prepared by the Congo's Central Directorate of Military Security, a Libyan agent named Bernard Yanga said the bombing of the French jet was part of a wider Libyan campaign to destroy American aircraft. The motive? Retaliation for the 1986 U.S. bombing of Libya, ordered by Ronald Reagan after the Libyans directed an attack on a West Berlin discothèque that killed two American servicemen and a Turkish woman.

Yanga, who worked days as a warehouseman, was not a willing confessor. But the Congolese, says a U.S. official, "were enthusiastic interrogators." Yanga's account, the Congolese report confirms, "was initially somewhat hesitant, and then became more coherent."

According to knowledgeable officials, Yanga and another Libyan gave sworn statements saying they had attended a

meeting in Tripoli in September 1988 to discuss the aircraft-bombing campaign against America. In fact, U.S. intelligence officials say, other evidence indicates that Libya began planning new attacks on American targets soon after the U.S. raid in April 1986.

Deep involvement. The September 1988 meeting provided more-specific evidence of Libyan plotting. Present, U.S. intelligence officials say, were Abdullah Senoussi, the brother-in-law of Libyan dictator Qadhafi, and Musa Koussa, a Libyan official who earned a Master's Degree at Michigan State University, writing his thesis on Qadhafi before he returned to Tripoli to head Libya's Center to Resist Imperialism, Racism, Backwardness and Fascism. Both men, U.S. officials say, were deeply involved in planning the bombings of both the French jet and Pan Am Flight 103.

Working from information developed by French and Congolese authorities in early 1991, FBI agents and Scottish police began re-examining the possibility of a Libyan connection to the bombing of Flight 103. Qadhafi's government en-

■ U.S. NEWS

joys close relations with the government of Malta, and on the morning the Pan Am jet exploded over Lockerbie, an Air Malta flight had carried several passengers to Frankfurt, where they boarded the first leg of Flight 103. Early on, investigators had tried to determine whether the bomb had been transferred to Flight 103 from the Air Malta flight. They had rejected the possibility for lack of evidence.

But the information developed during the investigation into the bombing of the French jet prompted another look for a Maltese connection. This time, investigators discovered that the two Libyans indicted last week, Lamem Khalifa Fhimah and Abdel Basset Ali al-Megrahi, had slipped an unaccompanied piece of baggage aboard the Air Malta flight. Both men are members of the Jawahira Security Organization, one of Libya's intelligence services.

The telltale timer. The bag delivered by the two Libyans contained a radio-cassette player with a bomb concealed in it. At Frankfurt, despite airline security regulations intended to prevent such an occurrence, the unaccompanied bag with the bomb in it was loaded aboard Pan Am Flight 103. The link was confirmed when a British forensic scientist matched a fragment of the bomb timer used to destroy the French jet with a tiny piece of



UTA. Wreckage from the French jet, in which 170 died, litters the Ténéré desert.

the timer on the bomb that blew up Flight 103: They were identical. After nearly three years, the first of those who murdered 270 people on a frigid winter night in Scotland now face criminal charges.

Does that mean Libya alone was responsible? The Bush administration has taken pains to avoid linking Iran and Syria to the Lockerbie bombing. Bush is eager for progress in the Middle East peace process, in which Syria is a critical actor, and Iran holds the keys to freedom for Westerners held hostage in Lebanon. But the evidence that Iran paid the Syrian-backed PFLP-GC to destroy an

American jetliner is compelling. Some U.S. officials suspect that after the PFLP-GC terrorists were arrested in Germany—weeks before the Lockerbie bombing—Ahmed Jibril, who has long had close ties to Qadhafi, handed off the operation to Libyan intelligence agents. There is no evidence proving that such a transfer occurred. But even if it did not, U.S. counterterrorism specialists say, Iran and Syria cannot be pronounced innocent simply because the Libyans beat them to the punch. ■

BY BRIAN DUFFY

CAN AMERICA STRIKE BACK?

Bad choices: military action, an oil embargo or kidnapping

● On June 21, 1989, probably long before William Barr ever dreamed of becoming the government's top lawyer, he drafted a secret memorandum. Its message: FBI agents have the authority to violate international law by seizing terrorists, drug traffickers and other fugitives overseas without obtaining the consent of the foreign countries where they are hiding. The opinion remains controversial, but law-enforcement sources say it was fitting that Barr's last public act before the Senate Judiciary Committee recommended his confirmation last week as the nation's 77th attorney general

was to announce the indictments of two Libyan officials for the bombing of Pan Am Flight 103.

In the cramped quarters of the Washington, D.C., field office of the FBI, the elite C-3 squad would likely get the call if it appeared that either of the Libyans could be grabbed. Both, however, are believed to be in Libya, where such an operation would be difficult and extremely risky.

Limited options. Still, there is ample reason to act: Libyan terrorists are becoming more active—and competent. A car bombing that killed a U.S. Army sergeant in Turkey a few weeks ago was

the work of the Abu Nidal Organization, U.S. officials told *U.S. News*. Abu Nidal is headquartered in Tripoli and bankrolled by Muammar Qadhafi.

Still, none of the retaliatory options available to George Bush is very attractive. An oil embargo would not be effective because Libya has invested heavily in downstream refining; several big facilities are incorporated in Switzerland and would not be subject to an embargo. Tomahawk cruise missiles or Stealth fighters could hit Libyan targets more accurately than U.S. bombers did in 1986, but military action is unlikely while the Middle East peace process is crawling forward.

That means that the indictments issued against the two Libyan intelligence officers last week may serve as little more than paper protests against governments that promote and pay for terrorist activity.

Race

Mississippi's New Chief Fought Race-Based Plans

By RONALD SMOTHERS

Special to The New York Times

JACKSON, Miss., Nov. 8 — When Kirk Fordice was driving home his campaign theme of passionate opposition to quotas and government affirmative-action programs in general, he was not just engaging in idle sloganeering.

Nor was the new Governor-elect of Mississippi running a copycat campaign, despite what some opponents said about his injecting race into the election and echoing the approach of David Duke, the former Ku Klux Klan leader and neo-Nazi who is running for governor in the neighboring Louisiana.

In fact, Mr. Fordice was the driving force behind a 10-year legal challenge to an Army Corps of Engineers program to set aside some contracts for minority and small businesses, and he was the leader of the industry group that backed a Supreme Court case that ended up outlawing most such minority set-aside programs.

Mississippi's first Republican governor in 115 years, is, friends and family members say, a man of "strong opinions and an outspoken manner." The 57-year-old owner of a Vicksburg construction company is a conservative who is no stranger to the White House.

He brings to the Governor's mansion a background of nearly 30 years of trying to build the Republican Party in the overwhelmingly Democratic State. In that process his role was mostly as a financial backer, and the only other elected post he has held was country election commissioner.

But his determination in pressing the case involving the Corps of Engineers speaks volumes about who he is and, some say, how he is likely to govern in the state with its strong Democratic Party and powerful Legislature.

That case, *Fordice v. Marsh*, ended with a little-publicized ruling by a Federal judge in July 1990 that the administration of a set-aside program for work on the Mississippi River had been characterized by abuse.

"It was very personal," he said of the lawsuit in an interview. "They almost put me out of business because of

the color of my skin. And that's just plain unfair. You can't make up for past discrimination by making others suffer."

At the same time Mr. Fordice was pursuing his own case, he was a player in an even bigger affirmative action case. He was a top official of an industry trade group, the Associated General Contractors, that helped finance a case called *City of Richmond v. Croson*. The case resulted in a United States Supreme Court decision in January 1989 that said that affirmative action and set-aside programs based on race were unconstitutional if they were not aimed at redressing specific incidents of past discrimination.

Affable in Campaign

Mr. Fordice's connection with these efforts was never prominent in his campaign. The picture that most voters got was of his straightforwardness and affability. But the Governor-elect, some friends say, often uneasily walks a tightrope between straight talk and a bluntness that is withering and just short of inflammatory.

In fact, throughout the campaign, said one friend, James B. Furr, a Jackson oil man, some of them held their breath fearing that the man who they considered "headstrong" and "full of magical self-confidence" would talk himself into some controversy or commit a costly gaffe.

But Mr. Furr, who has known Mr. Fordice for 35 years, insisted that it was Mr. Fordice's own forbearance, and not skillful handling by image

makers, that prevented such problems. "He was just full of self-confidence and not afraid to say anything."

His colleagues in the Associated General Contractors had long known of his unblinking manner as a spokesman for their cause. He has served on the group's executive committee since 1974 and from 1988 to early this year held a series of top offices including president. He often appeared before Congressional committees making the industry's case.

"They picked me for the armed combat testimony," he said with some relish as he discussed his industry in an interview.

His wife, Pat, said that the construction business bred a special kind of "focused" and no-nonsense approach.

A Family Business

Daniel Kirkwood Fordice Jr. was born Feb. 10, 1934, in Memphis, the son of a self-taught construction engineer who in 1948 left his job with the Army Corps of Engineers to start his own

construction company.

Kirk Fordice got his degree in civil engineering in 1956 from Purdue University and in 1957 earned a masters degree in industrial management. After serving two years in the Army, he began working with the family business, which specialized in fabricating the massive metal, reinforced concrete mats used to stabilize the banks of the Mississippi River. Because the work is heavily dependent on Federal contracts, the elder Mr. Fordice became active in the industry trade group and impressed on his son with the importance of such involvements.

At one point the business did as much as \$15 million a year but in the mid-1980's Mr. Fordice shrank the company to doing \$5 million in business annually while maintaining profits.

At the same time, said Haley Barbour, the state's Republican national committeeman, Kirk Fordice was among the few well-off businessmen in the state willing to devote time to Republican politics.

Mr. Fordice's reputation as a pit bull for the industry was burnished last March when he took on Senator Howard M. Metzenbaum, the Ohio Democrat who is chairman of the Senate labor subcommittee, in what Republican staff members and industry officials recalled was an aggressive defense of the construction industry.

"I had my work cut out for me," said Mr. Fordice, noting that the Senator had brought relatives of construction accident victims to testify in favor of new safety laws. "He took out after me like a schoolyard bully. So I just shot back at him and he was shocked because nobody else ever stood up to him like that. That's why the Associated General Contractors has guys like me who are businessmen and not professional lobbyist doing the testifying. It's a lot harder for them to intimidate us."

Ralph Thomas, executive director of the National Association of Minority Contractors, said that Mr. Fordice had forthrightly brought his opposition to set-aside programs to the hostile arena of the minority contractors convention in 1990 at which he "toed the conservative party line" on the issue.

"And a lot of us were impressed with his willingness to mix it up. I guess his election in Mississippi is sort of a mixed blessing for us. At least we know a governor with whom we can talk cordially and with whom we can agree on some things. Unfortunately none of those things involve minority participation in the construction industry."

Democrats Worry About Scope of Checks Inquiry

WASHINGTON, Nov. 9 (AP) — Democratic lawmakers are worried that the House ethics committee's investigation of bad checks written against accounts at the Capitol Hill bank serving House members will invade their privacy.

And they are insistent that the investigation be concluded quickly and that damaging material related to it be kept from Republicans.

Those are among the elements of a Democratic Congressman's written account of a meeting among party lawmakers on Thursday. The memorandum, written by Representative Terry L. Bruce of Illinois, was obtained by

The Associated Press, and its authenticity was confirmed by Mr. Bruce in a telephone interview.

Mr. Bruce would not say where the comments had been made, but a House official, speaking on condition of anonymity, said they were from last Thursday's meeting of the House Democratic whip organization. The House whip meets weekly with the whips from each state's delegation to discuss party positions and strategies, then pass the information to rank-and-file lawmakers.

"We need to protect our privacy and wrap up the investigation quickly," the memorandum said.

And reflecting the concern for privacy, it said, "One answer is that we will not put canceled checks into the hands of the Republicans."

The memorandum also reflected a worry that lawmakers would be judged by ethical standards that did not prevail before the extent of bad-check writing at the bank became public knowledge.

Addressing that concern, it cited comments at the meeting to the effect that the report resulting from the ethics committee's inquiry "will very likely be critical of the bank and its practices, not of individual members," and that "bounced checks will not be an

ethical violation."

The investigation was begun last month by a subcommittee of the ethics panel, the Committee on Standards of Official Conduct. It was ordered by a House resolution that will also shut down the bank by year's end.

Seeking Routine Violators

The subcommittee, three Democrats and three Republicans, is to investigate several issues related to the bank, among them whether lawmakers, officers or employees of the House "routinely and repeatedly" wrote checks against insufficient funds.

The inquiry follows a furor over findings by the General Accounting Office, Congress's investigative and auditing arm, that from July 1989 through June 1990, there were 8,331 bad checks written on accounts at the bank. The G.A.O.

said 134 account holders had written a total of 581 bad checks of \$1,000 or more.

The bank imposed none of the financial penalties that other banks charge depositors who write bad checks. Instead, it covered the deficiencies by taking money from other accounts.

In an interview, Mr. Bruce said his memorandum's reference to privacy had nothing to do with any effort to keep the names of chronic bad-check writers from becoming public knowledge. The lawmakers' concern, he said, was only that their private transactions not become public.

And the assessment that writing a bad check would not be judged an ethical violation, he said, was a shorthand way of saying that a person who had written such checks for only \$10 or \$15, and who had done so only rarely, would not be found at fault.

A Democratic leadership aide who attended the meeting said, "In part, what they were looking for was to be reassured that there would be differentiation between those who occasionally wrote a check for insufficient funds, as opposed to those who repeatedly and systematically abused the system."

Representative Matthew F. McHugh, the New York Democrat who will head the investigation, said in an interview that "the political climate is so negative" that members worry that the subcommittee will be pressured to recommend punishment, even by applying ethical standards retroactively.

"That's not going to be the approach," Mr. McHugh said. "We will make judgments about standards people had reason to know about at the time."