ECONOMIC STRATEGY INSTITUTE SEMINAR

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TO REBUILD THE ECONOMY

AND

BALANCE THE BUDGET

WITHOUT

INCREASING TAXES OR REDUCING BENEFITS

presented by

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The United States suffers from a wide spectrum of seemingly unrelated ills ranging from a declining economy and loss of competitiveness to environmental decay, inadequate health delivery systems and legislative gridlock. All of these problems are laid to incoherent national policy that flows from a common heritage of two-hundred-year-old institutional and structural deficiencies.

Beginning with reversal of the national inflation control strategy, the institutional modernization necessary to provide timely coherent national policy will be presented. The expected consequences for the nation are outlined, including the opportunity to rebuild the economy and balance the budget without raising taxes or reducing benefits.

- Thank you. It's a pleasure to be here this morning.

- Since our hosts have given us 40 minutes to rebuild the Economy and balance the budget without raising taxes or reducing benefits, let's move right along and redefine the problem.

PROBLEM DEFINITION

- Fifth Decade of Economic & Competitiveness Decline
- American Industry Thoroughly Disadvantaged
- Incoherent National Policy
- Outmoded Institutions and Structures
- Failure of the Legislative Process
  - Legislative Gridlock
- Institutional and Structural Deficiencies

SLIDE #1

- On March 20, 1992, in separate T.V. addresses, both the President and the leading Democratic contender agreed the U.S. was in trouble and must change.

- Then there was this incredible display of bipartisan unanimity. Both the President and the Contender agreed completely, and I mean they were in complete accord, that America's pressing problems

- Are the direct consequence of the opposing party's policies.

- And, of course, they are both correct, for the data show that

- Under the stewardship of both parties

- The United States has entered the fifth decade of a continuing decline in competitiveness and relative life quality.

- This decline is almost entirely of the nation's own doing.

- Industry operates in an environment created largely by government policies, laws, and regulations.

- If that environment is hostile or indifferent, business will not flourish.
- However, for generations, Ameriea's past successes have caused us to take our industry for granted.
- At best, U.S. industry was subjected to benign neglect.
- At worst, it became a convenient whipping boy.
- As a result:
- American industry has become thoroughly disadvantaged for essentially every significant determinant of trade competitiveness, from capital costs to technology procurement and deployment.
- Let us talk a bit about the
- **Role of National Policy:**
- The roles of Government & National Policy are poorly defined, but only the Government can offer a common vision of the nation's future, and
- Only the Government can take responsibility for the creation of the coherent national policy necessary to satisfy that vision.
- Rational planning and investment by the private sector cannot exist independent of government policy.
- Conversely, in the face of incoherent or invisible national policy, private planning and investment become a high stakes gamble instead of a reasoned exercise.
- Still, as we all know, on a clear day in Washington the list of incoherent national policies stretches to the far horizon.
- No Department of the Government has a monopoly on Incoherent Policy.
- Congressman Leon Panetta once said:
    - Counterproductive and conflicting Federal laws and policies abound in agriculture to the point where they sometimes sound like "Alice in Wonderland" creations.
    - There are tax policies that encourage investors to raise unneeded irrigated crops on easily erodible soil, using scarce water.
    - At the same time, the Government is fighting soil erosion and looking for ways to conserve that water.

- No Congressman would deliberately create Panetta's irrational agriculture policy.

- Tax policy, conservation policy, and food production policy have come together in an incoherent mess.

- How does this happen.

- The complexity of national issues has outmoded America's policy-making structure and institutions.

- Closer examination reveals incoherent national policy flows from a common heritage of two-hundred-year-old institutional and structural deficiencies.

- Cherished institutions that have served us well in the past are unable to provide the self-correcting, coherent policy needed to light the way to a better future.

- Unfortunately, unlike its trade competitors, the U.S. Congress simply does not possess the tools required to create coherent national policy.

- As a consequence, the American legislative process has literally broken down at both state and national levels.

- Major issues such as budget deficits, trade deficits, acid rain, competitiveness, taxes, etc., go unresolved year after year.

- And for good reason.

- National problems have become so complex and far reaching that large, well-organized sectors of the society are inevitably at odds with each other over conflicting but entirely legitimate self-interests.

- Without means to assess alternatives and reach public consensus, our elected representatives are unable and unwilling to take positions that must alienate a significant percentage of their constituents.

- Legislative gridlock is ensured -- the results appear everywhere. The public knows it.

- Yet, no matter how many Congressional incumbents are turned out by a frustrated public, nothing can change until the flawed process itself is fixed.

- The public consensus and legislative gridlock dilemma must be resolved.

- The country needs the means to effectively initiate and facilitate policy changes.

- Specifically, a consensus-driven mechanism is required to rationalize national policy by

- Anticipating changing conditions,

- Assessing the long-term consequences of existing and proposed policies, and
- Recommending to the Congress and the President mutually supporting national policies consistent with the nation's goals.
- In summary, if the United States is to regain economic leadership, two basic and massive institutional deficiencies must be addressed.

INSTITUTIONAL DEFICIENCIES

- **The United States Does Not Possess Institutional Means For Creating The Dynamic Coherent National Policy Required To Provide An Environment Conducive To Industrial Growth And Competitiveness.**
- **The United States Does Not Have Adequate Institutional Means To Effectively Identify, Procure And Deploy Needed Technologies In A Timely Fashion.**

SLIDE #2

- The second deficiency, Technology Policy, is admittedly an important subset of the first.
- Yet, it merits special attention.
- To remain competitive, the nation requires world-class institutions for the early identification and deployment of the next generation of technology.
- Consider the concept of
- **COHERENT NATIONAL POLICY.**
- It is difficult to conceive of a more boring or meaningless call for national action than the words Coherent National Policy.
- The words are lifeless. They have absolutely no sex appeal.
- Yet, the world's finest democracy will fail in the face of incoherent national policy.
- The central role of coherent national policy is best illustrated by the statement:

- Today, the single greatest threat to America's life quality and economic future arises from incoherent inflation policy that has produced economically unsustainable capital costs.

- Conversely: coherent inflation policy can satisfy every politician's dream by balancing the Federal budget without increasing taxes or reducing benefits.

- Coherent inflation policy will not cure all of the nation's ills, but it is a necessary condition for any sustainable, long-term recovery.

- The pervasive effects of incoherent national policy are impossible to comprehend in abstract.

- U.S. inflation control policy provides a stark example of the economic and industrial devastation that can be wrought by incoherent national policy.

- Incoherent inflation policy has been a major contributor to the acceleration of loss of U.S. competitivencss, deindustrialization, trade deficits, destruction of S&L industry, financial destabilization, stunted economic growth, and Latin American political instability - to name just a few for starters.

- Prolonged high inflation is considered detrimental to a nation's economic health.

- Classical economics teaches inflation is caused by too much money pursuing too few goods.

INFLATION

- CAUSE: Too Much Money Pursuing Too Few Goods
- CONTROL STRATEGIES
  - REDUCE DEMAND FOR GOODS
    - by reducing capital availability, increasing interest rates and inducing a RECESSION
  - INCREASE AVAILABILITY OF GOODS
    - by increasing capital availability, reducing interest rates and stimulating investment and PROSPERITY

SLIDE #3

- Using the world as a laboratory, a massive macro-economic experiment has been conducted by the free world's largest industrial powers.

- United States and Britain have chosen recession as the proper cure for inflation.

- Japan and Germany have chosen growth and prosperity.

- By every objective measure, prosperity has proven to be the winning strategy for containing inflation.

- Society holds most professions accountable for their recommendations - a doctor, lawyer or engineer can be sued.

- Please understand that some of my very best friends are economists, but

- If economists were held accountable for their advice, those practitioners who have prevailed with a single-minded pursuit of restrictive monetary policy would surely be subject to a world-wide, class-action malpractice suit.

- In spite of the enormous consequences,

- No evaluation seems to have been made of their experiment.

- The simplest comparative study of over two decades of inflation policy experimentation would have revealed

    - The relative ineffectiveness of restrictive monetary policy in accomplishing its designated task - controlling inflation - and

    - Any evaluation of the comparative economic growth and competitiveness of the four nations would have demonstrated the economic superiority of the prosperity paradigm.

- Incoherent, restrictive monetary policy not only offers no long-term cure for the inflation plague, but the side effects are as destructive as the disease itself.

COMPARATIVE INFLATION RATES

- Consumer Price Index comparisons for the four nations are stunning.

- Whether measured over two years or two decades, U.S. and British inflation has been two to twelve times greater than that of Germany and Japan.

- For the fourteen years of 1974-1988, U.S. inflation was three times that of Germany.

- In the recent three years of 1986-1988, the Federal Reserve increased interest rates 53% to stem inflation. Yet,

- For three years, U.S. inflation was seven times that of Japan. The United Kingdom experienced eleven times as much inflation as Germany.

- Furthermore, by its very nature, restrictive monetary policy must become increasingly ineffective as it destroys the economy to which it is being applied.

- Loss of a domestic market to a foreign product leaves domestic prices independent of local inflation policy.

COMPARATIVE ECONOMIC PERFORMANCE

- By design, U.S. inflation policy must cause the economy to oscillate between recession and recovery in a

- Roughly four-year cycle, often precipitated by presidential election demands.

- Restriction upon investment ensures that U.S. competitiveness must rachet downward during each self-induced recession, while our competitors continue to invest to capture market share.

- Prosperity-seeking nations -- Germany, Japan, and Japan's Asian acolytes -- have consistently high economic growth rates.

- 1991 GNP growth of South Korea, Hong Kong, Taiwan, Malaysia, Singapore, Thailand, and China was in excess of 6%.

- The recession-practicing, English-speaking countries -- U.S., Britain, Canada, Australia, and New Zealand -- have disappointing growth.

- Growth and prosperity depend upon investment, which in turn depends upon readily available, low-cost capital.

- Until recently, German and Japanese national monetary policies have held their capital costs at ¼ to ½ of U.S. real after tax capital rates.

- This gross tilt in the financial playing field has given our competitors an insurmountable, competitive advantage.

- Overall results can be summarized in a simple table.

SLIDE #4, NEXT PAGE

INFLATION AND ECONOMIC PERFORMANCE

1975 - 1992

	Recessions No.	GNP Growth Real Average/Yr.	Inflation Total for Period
U.S.	5	2.6%	156%
Japan	0	3.34%	74%

SLIDE #4

AN ECONOMIC GENGHIS KHAN

- Free of all public checks and balances, the Federal Reserve Board has created an economic Genghis Khan - an inflation policy that destroys everything it touches.

MISLEADING ECONOMIC DATA

- In addition,
- Bruce Merrifield shows that
- Misleading economic data has compounded the damage done by recession-stimulating monetary policy.
- Government statistics do not adequately measure the true status of the U.S. economy.
- Not only does the Federal Reserve dictate the wrong responses to signs of inflation by stimulating a recession, but the very signals that the Fed monitors are frequently in error.
- As a very recent, painful example
- In 1987, overstatement of inflation caused the Fed to increase interest ratios.

- The expected, but unnecessary, recession/depression of 1990-92 followed.
- Equally damaging, revised GNP data shows GNP declined 3% in the fourth quarter of 1989, or twice originally reported.
- As a result, the Fed failed to ease its monetary restrictions in time to limit the recession it had sought in 1987.
- Thus, counterproductive monetary policy actually created and amplified swings in the national economy.
- Now we come to the good part. This is where my glasses usually fog up.

TO REBUILD THE ECONOMY AND BALANCE THE BUDGET WITHOUT RAISING TAXES OR REDUCING BENEFITS

- On paper, it should be a relatively simple task to rebuild the economy and balance the budget.
- Thc calculations are straightforward, and the results compelling.
- Traditionally, industry and Government have struggled over tax policy.
- Washington currently labors to fashion capital gain differentials and industrial investment credits that might add 1% to 2% to industry's bottom line.
- This is nonsense that ignores the financial imperatives of the 1990's.
- Significant government and industry fiscal relief will not be found by tinkering with the tax codes.
- The answer will be found in inflation policy, not tax policy.
- Capital costs, not taxes, now drive industry.

SLIDE #5, NEXT PAGE

COST RATIO: INTEREST / TAXES

Non-Financial Corporations

Year	Prime Rate	Interest/Taxes
1948	2%	10.7%
1990	10%	155.0%

SLIDE #5

- In 1948 the prime rate was 2% and annual interest costs of American (non-financial) corporations were only 10.7% of taxes.

- By 1990, inflation policy had increased prime rate by 500%.

- Corporate interest costs soared to 155% of taxes - a 1500% increase.

- Industry's 1990 interest burden was now 55% greater than its tax load, and the U.S. tax burden is the lowest of all industrialized nations.

- If the United States had elected inflation policy that gave the 2% prime of 1948 instead of 1990's 10%, industry's after tax profits would have increased up to 50% .

- Lowering interest rates would give business 40-50 times more financial relief than a capital gains reduction.

- There is no other tax or policy change that can provide this kind of return to industry, and at the same time drastically reduce the Federal Budget deficit.

FEDERAL BUDGET DEFICIT

- The effect of lower interest upon Federal debt service is equally dramatic.

TO BALANCE THE FEDERAL BUDGET

WITHOUT

INCREASING TAXES OR REDUCING BENEFITS

1990: Prime @ 10% and T-Bills @ 8%

Federal Debt Service: $200 Billion

Refinancing at the

1948: Prime @ 2% and T-Bills @ 1.04%

Reduces

Federal Debt Service to $25 Billion

SLIDE #6

- Driven by Inflation Policy, debt service has been the fastest growing Government expenditure.
- In 1990, with the Prime at 10% and T-Bills at 8%, Federal debt service was $200 billion.
- The Deficit was $220.6 billion.
- If the debt had been financed with 1948's 1.04% T-Bills, debt service would have been about $25 billion, with a savings of $175 billion.
- The 1990 budget would have been near balance.
- Of course, public and private debt cannot be refinanced over night.
- It takes about five years to refinance 75% of existing Federal debt.

- At the same time, a growth-oriented, low interest inflation policy will reduce the exchange rate and stimulate the economy.

- A 1% GNP increase per year will decrease annual budget deficit about $80 billion in four years.

- We see, therefore that, without increasing taxes or reducing benefits, low interest refinancing and improved GNP growth will bring the budget within control by the mid-1990's.

- A great nation with 200 years of political and economic stability can command the low interest rates to both reduce the cost of government and provide industry with dependable, low-cost growth capital.

- The investment strategy that worked so well for U.S. housing can be adapted to other industries.

- The nation's fiscal exposure for insuring increased capital for investment in domestic productivity must be substantially less than the S&L bailout that can be recovered only through taxes or inflation.

- The banking and credit crisis are uncomfortably similar to the early days of the Grcat Depression.

- Felix Rohatyn has pointed out that

- The U.S. has forgotten the effective steps taken sixty years ago to shore up the financial system and provide investment capital.

- Instead of forcing undercapitalized financial institutions to close, the Government bought non-voting, preferred bank stock.

- The increased capitalization provided a basis for increased low-cost credit and investment.

- Resolution of America's economic and competitiveness problem must begin with a change in inflation policy.

- This must be followed by Institutional Modernization.

PROBLEM RESOLUTION
INSTITUTIONAL MODERNIZATION

Inflation

- Regardless of how a nation copes with prosperity, there is near-unanimity that low-cost, readily available capital must be part of the antidote for recession.
- During 1991, the Fed cut the Discount Rate nearly in half to 3.5%, bringing
- The 1992 Prime down to 6.5%.

INFLATION POLICY AND INTEREST RATES

YEAR	INTEREST RATES		
	DISCOUNT	PRIME	T-BILLS / 10 YR.
1960	3.5%	4.5%	4.12%
1992	3.5%	6.5%	8.0%

NOTE: 10-Year T-Bill rate is usually less than Prime.

SLIDE #7

- But long-term rates have barely moved and remain close to 8%.
- We see in this slide the effect of different inflation strategies.
- The market understands that the Federal Reserve is committed to inflation policy that will increase interest rates as the economy improves.
- This was not true in 1960 before the present inflation strategy had achieved an ecumenical status. Incidentally, 1960 was the last year the Federal Budget was balanced.

- National adoption of a long-term, low capital cost inflation strategy will require public reversal of nearly two decades of Federal Reserve policy.
- Implementation could require modifieation of the Federal Reserve's organization and role.
- At the very least, the Fed would be held aceountable, along with other Government policy agencies, for the nation's economic health and competitiveness.
- Under normal conditions, the inflation situation seems simple.
- Low capital costs will insure competitive exchange rates and provide the investment and productive capacity required to meet demand.
- With market place satisfaction of demand and healthy trade, inflationary pressures will be contained.
- Unfortunately, normal conditions seldom last very long.
- The world and its market plaee is constantly ehanging.
- But neither the Congress, the Administration, nor the Federal Reserve has the resources to anticipate changing conditions and bring the nation's policy players together.
- Japan has experienced no recessions sinee the 1973 oil shock.
- However, both Japan and Germany have wisely created institutional means to change national policy as needed.
- There are many world events that impact national policy.
- During WWII, Ameriea's civilian produetion was eut to a minimum while the population possessed unprecedented purchasing power.
- At the same time, to stimulate investment and war production, the prime rate was held at 1.5%.
- Inflation was negligible during and immediately after the war, for
- Temporary wage/price controls had been installed to successfully circumvent the probability of runaway inflation.
- It is reasonable to believe that there will be future market-distorting events:
  oil shocks, war, foreign restrictions upon vital eommodities.
- The United States laeks the maehinery to adjust national policy to accommodate change in a timely fashion.

- Until suitable institutions are in place to provide coherent national policy (including inflation/monetary policy),
- The American economy will continue to stagger from one avoidable recession to another.

PROBLEM RESOLUTION

PROBLEM RESOLUTION

- INFLATION POLICY REVERSAL
- INSTITUTIONAL MODERNIZATION
  - COHERENT NATIONAL POLICY

    Waits upon three institutional advances

    1. National Information Office
    2. Office of National Policy, Analysis and Assessment
    3. Public Consensus - Councils
  - NEEDED TECHNOLOGIES
    1. Identification
    2. Procurement
    3. Deployment

SLIDE #8

- It is important to emphasize that low-cost capital, the pressing first step for America's recovery, is an essential, but not sufficient, condition.
- The United States is in the fifth decade of economic decline, but incoherent inflation policy was not a factor until the late 1960's.
- America's leading trade competitors built their success upon long-established, institutional means for developing national policy and obtaining the necessary consensus for its implementation.
- Germany's 1966 Stability and Growth Act established a tripartite consultation process among labor, business and government.

- Japan's MITI, with more than 30 independent councils and over 200 standing committees, provides the public forum which enables Japan to rapidly reach a public consensus on national policy.

- To overcome its basic institutional deficiencies, America needs means to create coherent national policy,

- And needs means to implement those policies, including Technology policy, for which there is no existing organization.

- Coherent National Policy: Waits upon three institutional advances.

  1. **National Information Office**

     - A comprehensive, readily accessed, world-class information base is required for the nation's public and private policy makers.

     - No agency of the Government has overall responsibility for gathering the domestic and international information necessary to create industrial policy, much less national policy.

     - Information is gathered piece meal by a number of offices with different needs and objectives.

     - The Information Office will develop a coherent National Information and Statistic Policy directed to the basic factors influencing the nation's competitiveness and life quality.

     - These factors include U.S. and foreign economics, trade, production, customs, tariffs, market opportunities, technological innovation, scientific advances, industrial competitiveness, industrial policy, resource allocation strategies, government, business and educational policies.

  2. **Office of National Policy, Analysis and Assessment**

     - Although the Omnibus Trade and Competitiveness Act of 1988 calls for Competitiveness Impact Statements to accompany Congressional legislation, institutional means are not readily available to produce these statements.

     - The Policy Office would offer a vehicle for the ongoing examination of U.S. poliey.

     - Impact of national policy upon the nation's life quality, competitiveness, industrial competence, and technological development would be continuously assessed.

     - Drawing upon the data banks of the Information Office, the Policy Office would provide an early warning system for national and sectorial problems.

- Policy alternatives would be assessed and furnished to appropriate Councils for public reevaluation and debate.

- The IEEE has suggested that the responsibilities of the Office of Technology Assessment could be readily expanded to create the National Office of Policy.

- Then there is the search for

3. **Public Consensus - Councils**

   - In today's political arena, there is little hope of avoiding legislative gridlock on most major issues.

   - Standing, independent Councils, drawn from all sectors of society, will fill a major structural gap in our present institutions.

   - While the Information and Policy Offices will help define the viable policy alternatives, Councils will provide the public forums in which consensus can be forged.

   - With public acceptance of the equity of the tradeoffs and sacrifices inherent in any major public policy, Congress and the President will have renewed flexibility to create and administer national policy.

TECHNOLOGY - IDENTIFICATION, PROCUREMENT, DEPLOYMENT

- Finally,

- Successful implementation of coherent national policy frequently hinges upon the ability of the nation's technology policy - to identify, procure and deploy technology in a timely fashion.

- The United States does not possess the equivalent of the extensive, industrial technology-facilitating institutions of Japan and Germany.

- Identification of needed U.S. industrial technologies would be advanced by appropriate councils and new agencies, such as FIXIT.

- Procurement and Deployment of that technology will require developments as effective as those installed 100 years ago by the United States to create a world class agriculture industry.

- Underfunded NIST is an excellent first step, but literally a drop in the bucket.

- It is also time to redirect America's great national laboratories to provide the type of support given Japanese and German industry by their national laboratories.

CONSEQUENCES & CONCLUSIONS

- To summarize,
- Restrictive U.S. inflation control strategy, by any measure, including effectiveness in restraining inflation, cannot compete with the production-stimulating policies of Japan and Germany.
- The philosophical differences are ironical.
- Japan and Germany, by providing low-cost capital, have allowed the market place to satisfy demand and control inflation.
- The U.S. and Britain have elected Government intervention (restriction of capital), to limit the investment needed to satisfy growing demand.
- Ameriea's recovery can only begin with the publie burial of the old inflation paradigm.
- Industry and the public must be convinced that a pact has been made with their Government for a future that assures low-cost, readily available capital.
- Only such a commitment can bring long-term capital costs in line with short-term rates.
- A level financial playing field will rapidly enhance the competitiveness of U.S. industry.
- The exchange rate will drop and the trade deficit will decline.
- Lower interest rates automatically produce patient capital and a rational long-term business planning horizon.
- Publie savings and investment praetices will change.
- The price/earnings ratios of stocks, bonds and real estate will increase as investors seek to maintain income.
- The market value of the Nation's assets, including real estate, will increase and make a major contribution to the stabilization of the U.S. financial system.
- Bank and S&L failures will be reduced.

- The recent, sharp fall in interest rates has already made 1991 the first profitable S&L year in five years, and the best for banks in three.
- Lower interest costs and fewer thrift failures will reduce the final S&L bailout price tag.
- As an additional bonus, Latin American debt is made more manageable, allowing those nations to purchase more U.S. goods.
- With a prosperity-inducing inflation strategy, the Federal Budget can be balanced without increasing taxes or reducing benefits.
- But failed inflation policy is but one of a host of incoherent national policies.
- America's industry and life quality will continue to regress until Congress puts in place the institutional means needed to provide coherent national policy.
- Structural and institutional modernization can break the legislative gridlock that is destroying the productivity and public image of the nation's political process.
- The Presidential debate is being reshaped by a public groundswell for policy change.
- The issue inevitably turns on the speed with which institutional change can be effected if we are to secure a better future for our children.
- This afternoon,
- We have had to briefly examine only the more critical institutional changes.
- Perhaps there will be another time to explore structural alternatives.

Thank You