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ECONOMIC GROWTH AND JOBS

SUMMARY

Economic growth and employment can be viewed in both a short and long run context. In the short run, congressional concern centers on the appropriate mix of fiscal and monetary policies to keep real gross national product growing at a rate that is both compatible with the full employment of labor and capital and that avoids the pitfall of inflation.

In the short run context, the current economic expansion is significant. It has been underway since November 1982 and is now the third longest of the nine expansions since the end of World War II. Despite its length, the current expansion displays a number of unhealthy signs (e.g., the diversion of a considerable portion of demand abroad, a large and continuing budget deficit, a rising ratio of the national debt to GNP, and a rising debt obligation to foreigners) that suggest remedial actions which, if taken, have risks for the vigor with which the expansion will continue.

In the longer run perspective, the Federal tax structure, the size and types of expenditures, and a host of regulations can have a substantial effect on work effort, thrift, and investment which govern the rate at which the capacity of the economy to produce output grows. And it is the growth in this capacity that governs the rate at which the material well-being of Americans progresses. That well-being has not grown noticeably in the past decade largely because of the decline in the growth rate of national productivity. Clearly, a great challenge remains to restore the growth rate of the economy to produce output.

Transcending considerations of time is the Federal role in the distribution of income in the United States. Because the Federal role is so large in our economic system, Federal expenditures and revenue have the potential to substantially redistribute income, a redistribution that can alter national savings and capital formation. Fears are currently expressed that some aspects of the so-called safety net are having a deleterious effect on saving and investment.

ISSUE DEFINITION

The continuation of the current economic expansion will likely command a high priority among policymakers in the near term. It plays a crucial role in ensuring growth and employment of available productive resources, not only in the United States but in the world economy as well. Over the longer run, the focus of national policy will likely be on restoring the growth of the capacity of the economy to produce output which determines the long term growth of the well-being of Americans.

BACKGROUND AND ANALYSIS

The Federal Government influences economic growth and employment in at least three major ways. Because net Federal spending is a major component of aggregate demand, the Federal Government can exert a substantial short run influence on economic growth and employment by affecting the utilization of available productive resources. Federal taxes and expenditures, however, also affect the incentives to work, save, and invest which, together with productivity growth also affected by the Federal Government, help determine the rate at which the capacity to produce output expands in the longer run. Finally, Federal taxes and expenditures can substantially influence the distribution of income affecting both aggregate demand and the wherewithal for additions to productive capital. These influences are examined below.

The Current Economic Expansion

The current economic expansion entered its 5th year in December 1986. Only two of the nine expansions in the post World War II era have lasted this long. One occurred during the 2nd half of the 1970s and lasted 58 months while the other was the 106-month expansion during the decade of the 1960s.

While the present expansion is long, it displays a growing number of unhealthy characteristics which might lead one to question its continued longevity:

1. GNP growth during 1985 and 1986 has been insufficiently vigorous to bring about further reductions in unemployment. The rate for all civilian workers has hovered around 7.0% for 2 years.

2. An unusually large portion of aggregate demand growth during this expansion has been diverted abroad to purchase foreign goods and services.

3. While stimulative fiscal policy undoubtedly contributed to setting the current economic expansion in motion, the growth in GNP has been unable to reduce the budget deficit. That deficit continues to be large both absolutely and as a percentage of GNP.

4. The continued large budget deficits have contributed to a

marked rise in the ratio of the national debt to GNP, reversing a trend in effect since the end of World War II. A debt that grows faster than GNP is an untenable situation in the longer run.

5. An increasing portion of total U.S. debt is being acquired by foreigners. Unless they are prepared to lend an ever-increasing sum to the United States, the servicing of this debt will require that the United States have a surplus on the current account of the balance of payments. To achieve this will require a major adjustment in the international value of the dollar and the productive makeup of the U.S. economy.

The Policy Issues

The essential policy issues arising from the current economic upswing concern methods for dealing with the unhealthy aspects of the expansion while at the same time avoiding a downturn.

The 99th Congress decided to bring about a reduction in the budget deficit and growth rate of the national debt by enacting the Gramm-Rudman-Hollings legislation. The Federal spending targets established in this Act will, if attained, slow GNP growth and cause unemployment to rise in the short run. Neither of these effects need be dramatic, however. Fiscal restraint can be offset to some degree by monetary policy and by the private sector's response to lower interest rates that should follow when deficit reduction also reduces the Federal borrowing requirement in financial markets.

In the present international financial framework, monetary policy is especially effective as a policy tool for expanding domestic demand. Faster money growth reduces interest rates in the short run. This reduction expands the components of domestic demand that are sensitive to interest rates as well as causing an outflow of capital to other international financial centers. The latter brings about a fall in the international value of the dollar, encouraging U.S. export sales and discouraging U.S. purchases abroad (import purchases are diverted to domestically produced substitutes).

Thus, more rapid money growth could compensate for the contractionary fiscal policy called for by the targets set in G-R-H. To the extent that GNP growth can be stimulated, other shortcomings in the current expansion could be addressed: the current account and budget deficits could be reduced, a smaller portion of U.S. debt would be acquired by foreigners and the trend in the ratio of the national debt to GNP could be reduced.

It should be noted, however, that uncertainty handicaps the current use of monetary policy. This uncertainty characterizes the turnover rate or velocity of money -- the variable that lies between money growth and GNP growth. Velocity has been falling for the past 6 to 8 quarters at a more rapid rate than would have been predicted from historic patterns. Should this decline slow or be reversed, more rapid money growth could easily reignite double digit inflation. Because we do not know why velocity has declined so sharply or when the decline will come to an end, the use of monetary policy in the present environment is not without risk.

In two other ways the 99th Congress expressed interest in legislation that could influence short term growth and employment without involving the manipulation of aggregate demand. The first concerned direct means for dealing with the international trade deficit. There was strong sentiment for imposing tariffs or quotas on imports, especially from countries alleged to maintain barriers to U.S. goods or to engage in unfair trade practices. Interest has also been expressed in direct intervention in foreign exchange markets in order to maintain dollar exchange rates at levels that will better promote exports and reduce imports. Finally, there was also strong sentiment for a Federal initiative in the area of increasing U.S. "competitiveness" in international markets through cost reductions in U.S. goods by means of improved productivity, tax preferences, or subsidies. The advocates of these proposals cite among their advantages, either individually or collectively, that they would yield revenues that could reduce the budget deficit with favorable effects on U.S. credit markets and international capital flows, maintain and expand the domestic industrial base, increase U.S. employment, especially in the high wage manufacturing sector, and raise material well-being over time.

Opposition has arisen to all three of these proposals. Interventionist measures have been opposed because of their adverse effects on the U.S. standard of living as more resource-costly U.S. goods are substituted for less costly foreign ones. Exchange rate intervention has been argued as either inflationary or ineffective (if safeguards are undertaken to eliminate the inflationary impact). Export promotion through subsidies and tax policy has been opposed as equivalent and similar in cost to protectionist measures.

In all three cases opponents have argued that the proposed cures misdiagnose the cause. They contend that the large capital inflow to the United States from abroad has generated the trade deficits through its influence on exchange rates. Measures focused on trade, whether as protectionism or productivity-based "competitiveness" initiatives, cannot alter the trade deficit, but merely raise the exchange rate further and leave the trade balance the same. They argue that only a reduction in the relative attractiveness of U.S. capital assets will stop the net foreign investment that constitutes the capital inflow. This may be achieved by a reduction in U.S. interest rates, logically pursued by reduction of the budget deficit, which has contractionary effects, or by decisions on the part of foreigners that they no longer want additional U.S. assets, which will deprive the United States of a major source of financing, raise interest rates, and hurt interest-sensitive sectors of the economy. Accordingly, it is reasoned, no large boost in employment will come from initiatives focused on the international sector.

Another way of dealing with unemployment indirectly exists as well; it also raises a number of policy issues. There has been a growing realization that a number of Federal laws and programs enacted for various reasons may possibly have the undesirable side effect of raising the unemployment rate because they enable the unemployed to prolong their search for an alternative job (generous unemployment benefits), they price teenagers out of the labor market (minimum wage laws), or they keep certain wages too high (the Davis-Bacon mandate for wages on federally supported construction). There is also a sentiment that Federal services and programs are either inadequate or nonexistent in crucial areas such as

in aiding the transition of teenagers from school to work, in dealing with those unemployed for long periods, or in dealing with those unemployed because of trade-related foreign competition. Those viewing the unemployment problem in these terms have sought remedial action through legislation or the expansion of Federal employment services and programs. Others question whether this should be a concern of the Federal Government.

The Growth of Potential Output

A famous economist, in attempting to shift the attention of the profession to the short run, observed that "in the long run we are all dead." It is true nevertheless that it is the long run policies that govern the growth in the standard of living of any nation. Even a small rise per year in real per capita income can compound over a decade into a substantial increase in economic well-being.

The Federal tax code and the pattern of Federal expenditures can have a substantial effect on the growth of potential output by influencing the incentives to work, save, and invest. From these activities come growth in the labor force, the accumulation and enhancement of physical and human capital, and the rise in productivity -- in short, the material prosperity of the Nation.

Consider first the Federal tax code. Its effect on growth and employment comes not only through the level and progressivity of the individual tax rates, but also through special concessions that encourage and discourage particular economic activities. These special concessions can be a mixed blessing. Because the differential treatment of different endeavors can help redress shortcoming in individual's and firm's market behavior, they can improve economic efficiency. But often this disparity of treatment has simply redirected activity from endeavors that are otherwise economically justified. Economists have long been concerned that the tax code did not treat all types of physical investment equally. It encouraged some and discouraged others, distorting capital formation and the efficiency with which the market economy operates.

The preferred tax treatment of expenditures for research and development is an example of an endeavor favored by policy to compensate for the inferred inability of market incentives to provide an economically efficient level of the activity. Because innovation and new technology are important determinants of growth, these preferences promote the long run growth of per capita income. Even though in the long run employment of resources is thus enhanced, and investment in R & D increases total output and productivity, it is not clear what the outcome is for the distribution of income. It is not known, for example, whether mainly skilled or unskilled jobs are created, or a sharp and widening gap between high and low paying jobs occurs.

Federal expenditures have likewise had a mixed effect on growth and employment. There is little doubt that Federal expenditures for education directly enhance human capital and some expenditures represent a substantial subsidy for R & D activities. Moreover, public investment in the infrastructure that links various units of the economy has long been recognized as essential for growth (e.g., public outlays for highways, airports and airways, bridges, and waterways). Some, however, voice a

growing suspicion that certain expenditures, especially those connected to Social Security (together with the direct tax source that supports them), have a negative effect on the Nation's saving rate because they may substitute for individual saving for retirement -- saving that would otherwise make real resources directly available for investment and growth.

Essential to the amount of investment and, hence capital formation, is the amount a nation saves from its income. These savings represent resources that are not used for consumption and that are available for capital formation. The U.S. savings rate has not been especially high by the standards of other industrial nations. While that rate is substantially influenced by cyclical conditions, it has displayed relative constancy over a number of years. The savings rate, as well as the rate of productivity growth (which has undergone a marked slowdown in the last dozen years), is the focus of initiatives to boost growth by promoting investment. Proponents of this approach argue that it is not enough to redress market deficiencies with regard to long term growth, but to promote it. They advocate incentives to save more, and to change not only the kinds of investment that occur, but the total amount of it.

Opponents of this view observe that not all growth is desirable and that consumption -- if not now, then later -- is the goal of economic activity. They say the purpose of policy should be neutral with respect to growth and that policymakers should not second guess public preferences expressed in the marketplace. They further observe that we still know very little about the process of growth and should not lightly try to manipulate it and that many proposals to promote saving, such as a consumption tax, will likely have little effect.

The Policy Issues

The 99th Congress passed some important legislation that should influence the growth of potential output. Foremost among its actions was the landmark reform of the Federal tax system. This legislation lowered the rates and broadened the base of the income tax. This may have some effect on work effort and thrift in the long run, although the full effects of the reform will not be clear for some time. The reform also worked to equalize the taxation of income from various types of capital assets, reducing thereby the distortion in capital formation. This should increase the efficiency of resource use and economic well-being.

Legislation of the 99th Congress did not address decisive remedies for the low saving rate; the fall in the trend growth of the ratio of capital to labor, and the low growth in national productivity remain.

To the extent that the Congress can bring about meaningful reductions in the budget deficit, the Federal claim on the Nation's savings pool will diminish and additional resources should be available for private capital formation.

As investments in public sector communication and transportation networks have long been recognized as essential to growth, so too has the realization that these investments have been quite limited and that the public infrastructure is now in a state of some disrepair. Rebuilding these investments may have a high priority in the 100th Congress.

Perhaps one of the United States' great unsolved problems is discovering the cause of the dramatic fall in the national productivity growth rate in the early 1970s and the continuation of a low rate. This singular event has been responsible for the lack of growth in per capita real income over the past decade. Economists remain unable to arrive at a consensus explanation of this development.

While raising productivity growth may be high on the congressional agenda, how it is raised is also of concern. Many countries in western Europe have seen their productivity rates raised primarily because capital has been substituted for labor on a large scale. This method has caused a substantial run up of unemployment in these countries and many have failed to create any new jobs for more than a decade.

The Distribution of Income

When a government spends a sum equal to almost one-quarter of GNP and raises revenues equal to one-fifth of GNP, and the expenditures do not benefit everyone uniformly nor is the burden of taxation borne equally, the income of the Nation is redistributed in some measure.

The instances of congressional concern with those living in poverty and the fate of the middle class are too numerous to suggest that Congress does not worry about how income is distributed in the United States. These concerns have, in fact, been translated into the Federal social welfare system which has become a vast engine for redistributing income, not only among income classes, but also among different generations of Americans.

Some draw attention to the fact that income redistribution can affect the national savings rate because it may alter the incentives of individuals to save -- in effect the safety net is alleged to decrease private sector savings. Proponents of this argument are particularly concerned about the Social Security system in the United States and its relationship to the decline in the personal savings rate. And, as noted above, a decline in the savings rate, has an effect on investment, capital formation, and productivity -- the keys to long run growth and employment. Opponents of this view argue that the total private sector savings rate has remained fairly constant over time regardless of the social insurance system and the evidence of the effect of that system on personal saving is not conclusive.

The Policy Issues

The principal way in which the 99th Congress affected income distribution was through tax reform. Some 6 million low income individuals and families were removed from the Federal tax rolls. The decrease in the level of the individual income tax rates could also affect the future distribution of income.

A host of policy issues remain concerned primarily with the best way to reduce the number of individuals living in poverty in the United States. Since poverty is multi-dimensional (senior citizens, single mothers, families), policy initiatives for dealing with it will likely range from outright income transfers to the provision of subsidized day care, job training, remedial education, and the like. Others will claim

that the restoration of a more vigorous rate of GNP growth and the subsequent reduction in the unemployment rate will do more to reduce poverty than a host of specialized Federal programs.

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