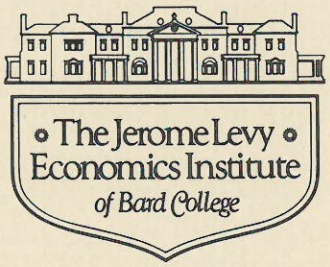
1-15-1992

How to Restore Long-term Prosperity in the United States and Overcome the Contained Depression of the 1990s

S. Jay Levy

David A. Levy

HOW TO RESTORE LONG-TERM PROSPERITY IN THE UNITED STATES AND OVERCOME THE CONTAINED DEPRESSION OF THE 1990s



S Jay Levy
Chairman

David A. Levy
Vice Chairman, Director of Forecasting

January 15, 1992

The Jerome Levy Economics Institute Bard College, Annandale-on-Hudson, New York 12504

The Jerome Levy Economics Institute of Bard College, *founded in 1986, is an autonomous, independently endowed research organization. It is nonpartisan, open to the examination of diverse points of view, and dedicated to public service.*

The Institute believes in the potential for the study of economics to improve the human condition. Its purpose is to generate viable, effective public policy responses to important economic problems. It is concerned with issues that profoundly affect the quality of life in the United States, other highly industrialized nations, and countries with developing economies.

The present research agenda includes such issues as financial instability, poverty and problems associated with the distribution of income, and economic growth. In all its endeavors, the Institute places heavy emphasis on the values of personal freedom and justice.

The Forecasting Center *of The Jerome Levy Economics Institute was established in 1991. Its mission is to analyze and forecast U.S. economic conditions and contribute to public understanding of the government policy issues concerning employment, price stability, the standard of living, and other aspects of economic performance.*

The Forecasting Center employs a macroeconomic approach that has a focus on the activities and resulting flows of funds that determine aggregate corporate profits. The Forecasting Center publishes Industry Forecast, *America's oldest publication dedicated exclusively to economic analysis and forecasting.* Industry Forecast *was established in 1949 by Jerome Levy and S Jay Levy.*

HOW TO RESTORE LONG-TERM PROSPERITY IN THE UNITED STATES AND OVERCOME THE CONTAINED DEPRESSION OF THE 1990s

S Jay Levy
Chairman

David A. Levy
Vice Chairman
Director of Forecasting

The Jerome Levy Economics Institute of Bard College

Blithewood, Bard college, Annandale-on-Hudson, New York 12504

CONTENTS

Executive Summary

The American economy has severe, long-term problems that have no post-World-War-II precedent. The problem facing policy makers is not merely how to end the recession, but rather how to counter a long-lasting malady of which the recession is merely a part.

The present impediments to prosperity are not familiar, cyclical problems such as overproduction of goods for inventory or a spurt in interest rates. Rather, what America has overproduced is private sector capacity—too many auto plants, too many office buildings, too many shopping centers, too many fast food restaurants, too many business facilities of numerous other kinds.

A great many industries—goods, services, construction—are unable to adequately utilize their capacity, face cutthroat competition, struggle to service huge debts, and are more likely to attempt shrinkage than expansion even when the recession ends. As a result of past excesses and mistakes, a great tide of financial crises is sweeping America.

These problems are characteristics not of a recession, but of a depression. Fortunately, it is a *contained depression*. Economic and financial stabilizers like deposit insurance and a large federal government sector are preventing the kind of collapse and deep depression that occurred in the 1930s. Nevertheless, the economy will continue to seriously underperform at least through the first half of the 1990s. Even when the economy shows improvement, as in mid-1991 and, quite possibly, in 1992, the progress will not last long or amount to much.

The key problem that government must address is the weakness of private investment. Government can encourage private investment, but it will still be low. This problem is critical because strong current investment is fundamental to an economy's ability to generate current profits. If profits are lacking, production, employment, growth, and future investment will suffer.

The proposed program for meeting these challenges calls for the following:

* Increased public investment in much needed infrastructure, which would offset the weakness in private investment and bolster the economy.

* Conducting federal public investment in a business-like manner despite the federal budgetary accounting system, which miscasts investments as current expenses. The key is an innovative but simple financing technique.

* Lower interest rates to foster investment, growth, and stability.

* A shift toward more reliance on public investment as a fiscal stimulus and less on deficit-financed public consumption.

* A transitional program in recognition of the time needed to gear up public investment spending: temporary reductions in withholding taxes and a revival of revenue sharing, especially for education.

The failure of the federal budget to distinguish between expenses and investments has led to serious neglect of the nation's long-term interests. To circumvent this problem, under the proposed program the federal government would

not make payments directly for infrastructure. Rather, the Treasury would finance projects undertaken by either state and local governments or government enterprises by buying zero-interest (not zero-coupon) bonds. In effect, The United States Government would subsidize the interest payments on these projects, markedly reducing the borrowers' overall costs. This subsidy would greatly encourage public investment spending. Yet it would not appear as a lump sum expenditure in the federal budget.

Instead, the Treasury would incur a series of annual expenses equal to its negative interest spread. Thus, the cost of the government's investment would be spread over the life of the project just as it would be if the government's budget accounting reflected Generally Accepted Accounting Principles (GAAP).

The program would have numerous controls, such as applying only to tangible, physical assets (structures and equipment), requiring some private finance, and requiring explicit plans for repayment of the Treasury-held debt.

As many economists have asserted, the country's future productivity, competitiveness, and quality of life will all suffer without a large increase in public investment. Unfortunately, data on the needs for increased infrastructure investment, while persuasive, are woefully incomplete. Conservatively, America needs at least $45 billion a year in additional public infrastructure spending. A comprehensive government audit of investment needs would likely indicate a much larger figure.

The contained depression will continue to reduce inflation and make an overwhelming case for a new era in monetary policy. The Federal Reserve can aggressively promote growth in the 1990s.

No matter what government does, the national debt/GDP ratio will grow during the contained depression. Still, it will not approach a "point of no return" where the government is faced with default or rapid inflation. This ratio will shrink after the contained depression.

Government policy cannot eliminate the depression, but it can improve its containment. This program will not smooth all the bumps along the way, but government can markedly improve economic conditions during the next several years while laying the groundwork for subsequent robust growth.

I. INTRODUCTION

The United States economy is afflicted with more than a recession, and it needs more than a jump start. Its dismal performance over the past three years is perplexing only when the economy's ailment is miscast as merely a short-term, business cycle phenomenon. The real affliction is considerably more profound.

Despite the abundant and widely noted evidence of massive overbuilding, misplaced investment, excessive capacity, over-speculation, financial crises, and painful corporate restructurings, both private citizens and public officials generally fail to connect these phenomena and recognize that the disease of the 1990s is a grave, long-lasting affliction. These imbalances and reactions are characteristics of a depression. The slump that began in 1990 is, indeed, a depression, albeit one contained by various stabilizing forces. One of the attributes of a depression is the occurrence of minor expansions and contractions over its duration. Government remedies designed for short-term recessions will not address the extended, and in many cases worsening, problems of the 1990s.

The United States government, preoccupied with its debt situation, sacrifices the nation's future through neglect of its nonfinancial real assets such as infrastructure and education. With a competitive labor force, efficient infrastructure, effective financial system, and healthy business sector, America will thrive in the global economy of the twenty-first century and regain financial strength. Without these assets, the country and its standard of living will suffer.

Left alone, the economy will continue to perform dismally for much of the 1990s, perhaps for the entire decade, with lasting social, political, and economic damage. However, the United States has a great opportunity to pull itself out of this morass and remobilize its basic economic potential. This nation has enormous wealth, and neither the federal government's fiscal predicament nor the problems of the 1990s diminish the economy's great, underlying strengths. The United States is richly endowed with resources, scientific talent, the facilities for advancing the technologies on which growth depends, and an enormous stock of physical assets. It also has a heterogeneous, dynamic society with a unique ability to revitalize itself.

Never in the postwar era have the stakes for economic policy-makers been so high. The United States should pursue an aggressive but disciplined program of public investment in economically warranted and often badly needed facilities. Government must also reexamine many of the notions that have underlain monetary and fiscal policy but do not apply under current conditions. A bold yet sound program will generate employment opportunities, help stabilize the financial sector, improve the quality of American life, build a competitive platform from which to vie for international markets in the twenty-first century, restore faith in government, and nurture hope and optimism among a now discouraged, worried citizenry.

II. AMERICA'S ECONOMIC PROBLEM: THE CONTAINED DEPRESSION OF THE 1990s

Why The Economy Will Not Get Better

TV broadcast time and newspaper space are devoted increasingly to the unique, perplexing, and stubborn aspects of the economy's slump. Many questions have arisen since the downturn began:

Why did a recession begin in 1990 without the usual buildup in inventories or rise in interest rates?

Why did the economy fail to recover in 1991 as it usually does once interest rates have fallen, inventory liquidation has halted, and housing starts have been rising for several months?

Why are so many firms failing and so many workers at surviving corporations losing jobs that will never be replaced? Why do analysts say that most of these cuts would have to occur even if the recession were over?

Why has America suffered unprecedented financial problems in banks, saving and loans, pension funds, insurance companies, the corporate bond market, real estate, and elsewhere, all within a few years?

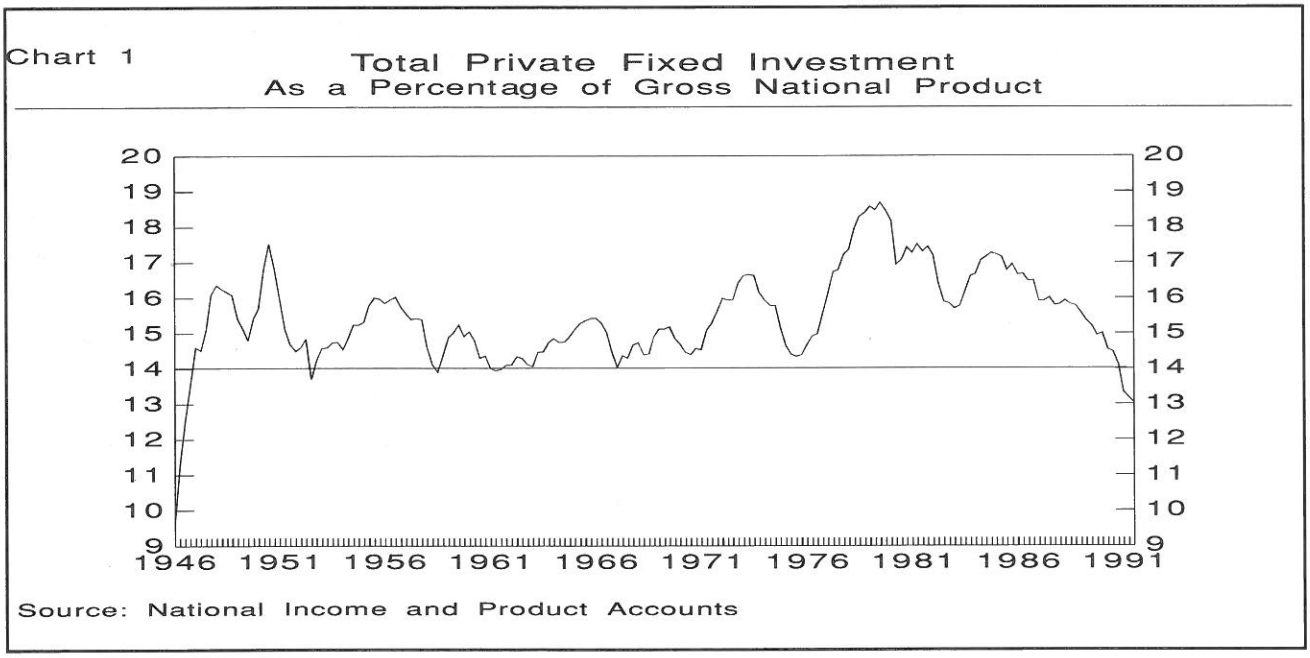
Why are so many people — consumers, workers, executives, voters — so frightened about the economy?

If the latest American recession does not appear to fit the pattern of the previous post-World-War-II business cycles, there is good reason. *The economy is suffering not from a short-term disruption in demand or an inventory overhang, but from having too many of the wrong assets built at the wrong time, bought at excessive prices, and paid for with too much debt.*

As the 1980s were coming to a close, a retrenchment began in fixed investment—residential and nonresidential construction as well as business outlays for equipment. Gluts of structures and equipment are causing cutbacks in construction and capital outlays. Financial problems increase as buildings and other assets failed to earn enough to service the debts that financed them. A growing epidemic of insolvencies has been affecting financial institutions across the country. The financial troubles transcend regions and industries and involve both public and private entities.

Until 1990, the United States had experienced four-and-a-half decades of generally expanding private fixed investment. The only interruptions were brief recessions. Now, for the first time since the 1930s, America is experiencing an extended retrenchment in investment (chart 1). Such investment slumps tend to occur decades apart. For an economy to work its way into the

Chart 1



kind of financial and excess capacity situation that now prevails requires many years of overbuilding, overspeculation, and overleveraging.

Retrenchment in fixed investment is a depressionary, not recessionary phenomenon. Here is a useful distinction between recessions and depressions: Recessions are economic contractions necessitated by short-term overproduction; depressions are caused by long-term overinvestment. The primary imbalances in recession are excessive inventories. In a depression, the imbalances arise from overbuilding productive capacity and creating excessive debt. Inventory imbalances can be corrected quickly; excess capacity and debt take years to absorb.

Indeed, the United States has entered a depression. The outlook is for a number of ups and downs during a lengthy, depressed, and financially traumatic period. Fortunately, this is a *contained* depression, which will not come close to the 1930s on such measures as unemployment, decline in GNP, lost savings, and bankruptcies. It is contained in two ways:

1. The basic integrity and function of the financial sector is protected by government safeguards, particularly deposit insurance and a central bank poised to provide liquidity when crises erupt.

2. The sheer size of the federal government makes it an effective flywheel on the economy. Whereas federal spending was less than 3% as large as gross national product in 1929, it is almost one-fourth as large as GNP today.

How bad will the contained depression be? The economy, unless government acts forcefully and effectively, will remain deeply troubled at least until the second half of this decade and perhaps through 2000. The unemployment rate will not reach the 1930s high of 25%, but it may at times be 10%, and it will linger at uncomfortably high levels. Real GNP, which fell over 50% from 1929 to 1933, will be limited to small, single-digit declines in down years, and it will register a small gain over the course of the contained depression.

Indeed, the economy will be able to muster spurts of expansion, possibly one in 1992 , but beware. These expansions will tend to be short-lived and uneven, and they will not restore satisfactory levels of income, employment, or profits. Moreover, the risk of a new downturn and expanded financial crises will be chronic.

The intractability of the contained depression is deeply rooted. Most, if not all, of the 1990s will be required to absorb the excess office, hotel, and retail space. Although the home-building industry is not burdened by a serious backlog of unsold single-family dwellings, it faces serious impediments. Slow population growth, unemployment, economic uncertainty, and doubts about residential real estate as an investment are forestalling renewed vitality in the demand for new houses and apartments. Low interest rates will trigger spurts of dwelling construction, but the negative influences will generally dominate. Meanwhile, industries with excessive capacity ranging from steel to automobiles, from beer to pantyhose, from air travel to fast food, and from dairy farms to department stores—will be disinclined to expand.

In addition to these problems, and in fact exacerbating them, will be a financial climate that is increasingly unfavorable for new investment. For all the skeletons to come out of the closets of financial institutions and for the failures and insolvencies to be resolved one way or another will take years. Once the financial sector regains its health, the willingness of banks and other institutions to finance private fixed investment will slowly return.

As long as the economy is mired in these private sector problems, the national debt will grow rapidly. The extent of financial problems in real estate and elsewhere will repeatedly exceed estimates and lead to larger-than-expected government borrowing to finance RTC and FDIC obligations. Moreover, the economy will be heavily dependent on fiscal stimulus, one of the two mechanisms containing this depression. Any marked reduction in the deficit will lead to a weaker private economy, falling tax revenues, and a bigger deficit once again. Not until the contained depression ends will the private sector grow out of the need for fiscal stimulus. (Section VII discusses the deficits and the national debt.)

Although the swelling national debt will cause consternation, price trends will be gratifying. Inflation, already on the retreat, will tend to diminish during the next few years. Weaknesses

in commodity markets, low job security, broadening international competition, heavy pressures for reducing overhead and raising productivity, and deflation in asset prices will be among the major downward influences on prices. (Section V discusses the inflation outlook.)

Investment Is Essential to Present—Not Just Future—Prosperity

But why is a poor outlook for private fixed investment such a serious problem for the economy? Can other types of expenditures, such as purchases of services, take up the slack? No. All sectors in the economy are *not* equal; investment plays a special, vital role.

Any American can understand the value of building factories, machines, houses, and highways today so that we will have more goods and services to enjoy tomorrow. Yet the benefits of investment are not all in the future. A healthy capitalist economy simply cannot exist without a solid, upward trend in investment. Investment is essential to generate flows of funds that become corporate profits.

Economists have long recognized the leverage that investment has on an economy. They note that a $1 increase in investment results in an increase in the economy's total income of several dollars. The phenomenon is commonly called the "multiplier effect," and it is explained through a mathematical demonstration of ripple effects. However, to most Americans, even many sophisticated business executives, this explanation of the impact of investment on economic activity is somewhat cryptic.

The most direct explanation of investment's leverage on the economy is through the link between investment and profits. If business is to secure profits, and to do so without reducing the wealth of someone else — the household sector, public sector, or rest of the world — then the total wealth of the economy must increase. The only way to increase wealth is to produce assets of lasting value, notably houses, public buildings and equipment, and business structures and equipment. As long as society's stock of fixed assets is increasing, all sectors can gain.

In an economy in which over 80% of the domestic product and 85% of the employment occurs in the almost entirely profit-motivated private sector, the level of profits is important, indeed, crucial. If, on the one hand, profits are greater than necessary to induce the full utilization of the economy's resources, they are excessive, inflationary, and not in society's interest. On the other hand, if profits are inadequate, then employment, production, investment, and income will all suffer. If profits fall sharply, the economy contracts. If they disappear, it collapses. American business was completely denied profits in only two years during this century: 1932 and 1933. The consequences for employment, income, and growth speak for themselves: GNP shrank in half from 1929 to 1933 and employment fell about 20%.

A slightly more involved but revealing way to understand the role of investment in generating profits is to introduce money flows into the discussion. Consider a simple economy in which the business sector produced only consumer goods and paid, say, $100 billion in wages to the household sector. Consumers would have only $100 billion to spend, and business could receive no more than the $100 billion in revenue—just enough to cover payroll costs. It could not profit. But add a capital goods sector that pays, say, $20 billion in wages, and the consumer goods sector has potential revenue of $120 billion against only $100 billion in wage expenses. As for capital goods, they are bought by firms with borrowed money or savings. These purchases are regarded *not* as expenses, that is charges against profits, but as investments. The expenses associated with these investments are not incurred all at once but spread out over a number of years as depreciation charges.

Of fundamental importance to the proposal set forth in this document is the ability of government fiscal activity to contribute to total business sector profits. Government investment or government deficit spending could be substituted for private investment in the example above. It could provide the household sector with $20 billion of purchasing power by paying out more in interest, salaries, transfer payments, and purchases than it receives as taxes. But what the government buys in the course of these transactions is of critical importance.

If none of the government's outlays are for new, enduring assets, then the government is augmenting corporate sector wealth at the expense of its own. But if the government's net cash

outflows do not represent deficit spending but rather investment in new satellites, highways, school buildings, etc., it is increasing society's wealth, not diminishing its own.

The Evidence of Excessive, or Misplaced, Private Investment

After a decade of criticism of America's failure to invest enough to keep up with the Japanese, the proposition that investment has been excessive may arouse suspicions. Nonetheless, any shortcomings that may have occurred in manufacturers modernization programs are outweighed by other kinds of excesses, including manufacturing investments in capacity expansion. Manufacturers' capacity utilization rate has been on a secular decline since the mid-1960s. Each cyclical peak was lower than the preceding one, indicating an increasing excess of capacity (chart 2). Moreover, these figures understate the problem, because a substantial amount of spare capacity in the early postwar decades reflected intentional provisions for anticipated, rapid production growth. By contrast, most manufacturing firms correctly anticipate poor growth prospects in the 1990s. Automobile, computer, defense, and heavy industrial equipment industries are highly visible examples.

Beyond manufacturing, excess capacity is almost everywhere: communications, airlines, construction, architecture, farming, legal services, retailing, and so forth. The waves of restructuring layoffs that are making frequent headlines are primarily not recessionary phenomena, but long-term adjustments to previous overexpansion.

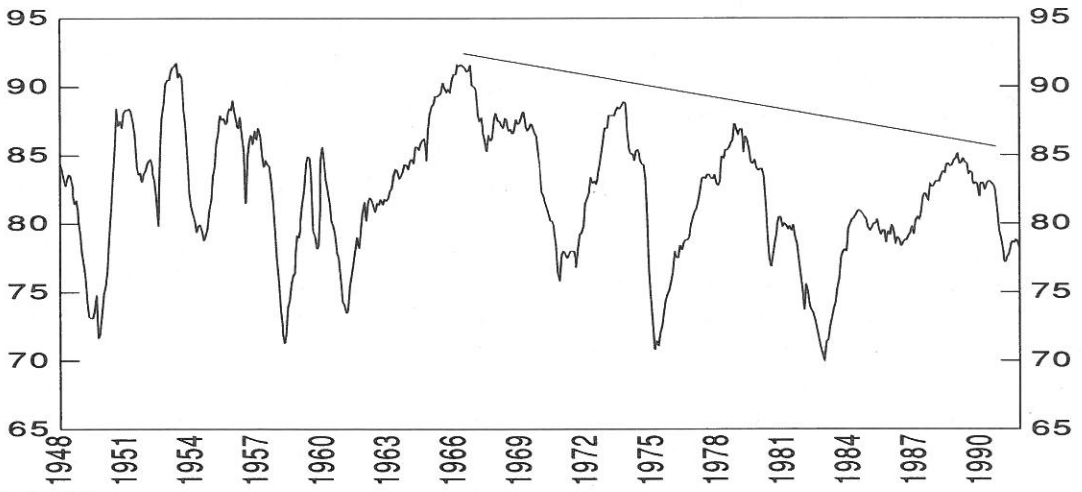
Nowhere are capacity excesses more apparent than in commercial real estate. Office vacancy rates (chart 3) are recorded at 18% to 20%, depending on the source, but these figures undercount small properties that probably have considerably higher proportions of their space unlet. Retail buildings, hotels, and apartments are similarly overbuilt.

A Compelling Need For Government Help

The contained depression is not a doomsday scenario. But if every recession is a tragedy, this period threatens to be an especially wrenching one. Many people will suffer unemployment, poverty, despair, shattered career opportunities, and other losses that in many cases will long outlive the contained depression. Businesses with bright futures will be stunted in efforts to pursue boldly their potential, and many will be wiped out. Federal fiscal problems will continue; state and local budget crises will worsen; and austerity will hurt the quality of life for all and weigh heavily on those with modest incomes.

Government can more effectively contain the depression and eventually lead the nation into a new period of gratifying growth. Government's choices will not only affect America

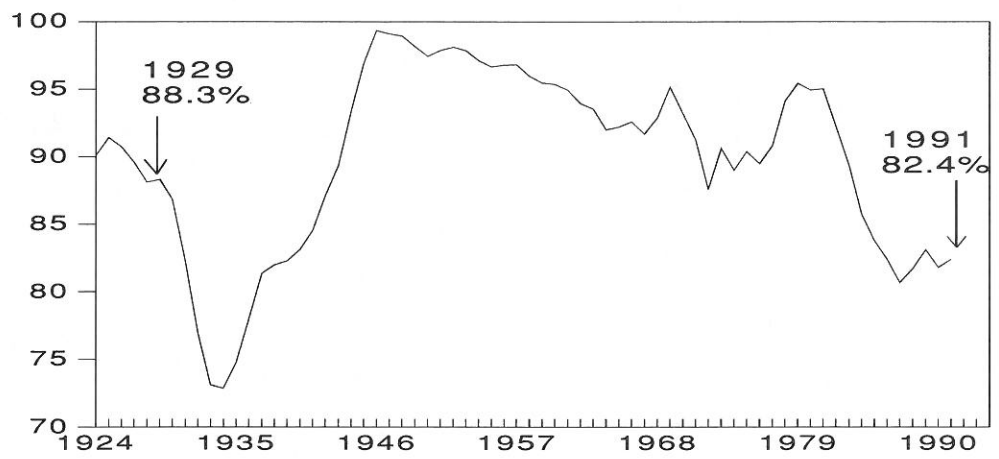
Chart 2 Manufacturing Capacity Utilization (%)



Source: Federal Reserve

Chart 3

National Office Occupancy Rates
(Building Owners and Managers Assn. Int'l.)



in the 1990s, but also its international competitiveness, political leadership, and standard of living in the approaching century.

III. A PROGRAM FOR ECONOMIC STABILITY AND GROWTH THROUGH PUBLIC INVESTMENT

Setting Policy Objectives

With such a formidable set of serious, even alarming economic challenges, where does government begin? First, by correctly identifying the economy's fundamental problems instead of focusing on and attacking the symptoms. Second, by setting realistic objectives based on what policy can and cannot do.

The federal deficit, unemployment, state and local fiscal crises, credit crunch, and other front-page woes are not independent problems; they are largely symptoms of the contained depression. Because government's focus is on these symptoms, especially the deficit, policymakers are constrained from addressing issues that will vitally affect the nation's future. The United States has long-term problems that are distinct from but intertwined with the contained depression. Its concerns include global competitiveness, education, social stability, the environment, international relations, and world stability.

Government policy must be liberated from the myopic focus on slashing spending with little regard to its strategic importance. Only by examining the long-term costs and benefits of alternative policies can the country effectively maximize its economic and political strength in the approaching century. Indeed, one may draw an analogy between the United States government and a promising but troubled corporation. If that firm focuses only on maximizing its net cash flow in the short run, it may sell strategic assets, slash research and development programs, eliminate employee training, curtail customer service, skimp on product quality, and otherwise sacrifice its future. If the firm is a viable, ongoing business, it should instead raise the funds it needs to build for its future. Right now, America is sacrificing its future by neglecting long-term national interests.

If government is to act rationally and in the nation's best long-term interests, it must consider the following realities in setting policy objectives:

* Policy cannot make the contained depression go away, but it can affect how well it is contained. Markets inevitably must correct imbalances such as excessive speculation, overbuilding, and poorly conceived loans. Policy can minimize but not eliminate the resulting dislocations.

* Market adjustments will and must eliminate jobs, but policy can create new jobs.

* Policy cannot induce and sustain strong, aggregate private, fixed investment during the next few years because of the excess capacity that now exists. But policy can create an environment that minimizes the retrenchment and accelerates investment that arises from advances in technology.

* Policy cannot prevent rapid growth of the national debt in the 1990s, but policy can greatly increase the proportion of the new debt that finances increases in needed public assets. It also can keep the debt/GNP ratio below the record 1946 levels, and it can greatly reduce the cost of servicing the debt.

* Policy can achieve and maintain low interest rates, and it can promote growth in the 1990s without a reacceleration of inflation.

* Policy can address the pressing need for national investment in infrastructure and other long-term assets.

Outline of a Program for Economic Stabilization and Growth

The following is the outline of a proposed plan to minimize the financial trauma of the 1990s, reduce unemployment, stimulate overall growth, and build a sound foundation for prosperity, international competitiveness, and an improving quality of life in the next century.

1) *A major increase in national investment in infrastructure.* The program would include both direct investment by the federal government and federal inducements for state and local investment. Total annual spending on new fixed assets would be at least $45 billion larger than at present, and probably much more.

2) *Lower interest rates.* Monetary policy should drive short-term interest rates down to the range that prevailed in the early 1960s, a period of little inflation. The Federal Reserve and the Treasury should undertake a coordinated program to bring long-term rates down as well. (Treasury bills yielding 3% and bonds at 4% were typical of the early '60s.)

3) *A new procedure for financing public investment.* The federal accounting system miscasts public investment as public consumption and as a contributor to the federal deficit. Ideally, the federal government should implement an accounting system that conforms to Generally Accepted Accounting Principles (GAAP) by (a) separating accounts for investment and operating expenditures and (b) amortizing debts and depreciating investments. However, taking a realistic view of the political and practical obstacles to replacing the accounting system used in federal budgeting any time soon, if ever, another approach is necessary. Even while following its present accounting rules, government can adapt a financing mechanism from the business sector that prevents expenditures for structures and other durable assets from being viewed and classified as current expenses.

4) *Abandonment of self-defeating belt-tightening as a strategy for deficit reduction.* The federal government needs to alter its clearly unsuccessful deficit-reduction strategy of tax increases and austerity, which is counter-productive under present economic conditions. It should instead work toward long-term deficit reduction through: (a) decreases in the rate of interest paid on the national debt and (b) increased revenue resulting from growth in corporate and personal incomes.

5) *Actions to prevent the U.S. economic stimulus from being exported.* The United States should exhort other industrialized nations to pursue their own stimulative policies to support the world economy. And as needed, the dollar should be allowed to weaken.

6) *A transitional stimulus. A large, temporary, broad-based tax cut and a revival of revenue sharing.* Because most public investment cannot be started instantaneously and many projects will take two years to reach the construction phase, the economy needs interim help. The government should inject funds into the economy through temporary tax reductions and grants to states, especially for purposes that aid the nation in its efforts to promote productivity and competitiveness over the long term. Outlays to halt destructive cuts in school budgets would be well-advised. Of course, such emergency spending alone would not constitute an adequate na-

tional program for achieving educational goals.

Major Concepts Behind the Program

Underlying this program are three major concepts, which are summarized below. How the components of this program would work together and how they would effect price stability, the national debt, and other economic concerns are discussed more fully in the sections that follow.

Concept 1. The centerpiece of this program is a response to the compelling juxtaposition of excesses in private capacity against serious inadequacies in the public infrastructure. An expansion of public sector fixed investment can fill the gap left by retrenchment in private sector investment. Investment in new fixed assets, whether public or private, plays a crucial, irreplaceable role in generating prosperity. A major increase in public investment will add to total investment directly *and* also indirectly by minimizing the contraction in private sector investment. Public investment will stimulate private investment in two ways: (1) firms working on government projects will place new orders for equipment and other capital assets, and (2) the public investment will stimulate the economy, improving sales and profits, easing financial problems, and thereby encouraging private investment. (Section IV)

Concept 2. Low interest rates are not sufficient by themselves to stimulate satisfactory economic performance, but they are another vital part of the program for growth. The uncontained depression of the 1930s demonstrated that the economy can suffer from such extreme weakness in the demand for and financing of private investment that it can remain mired in depression and deflation for years despite the most favorable interest rates imaginable. While the poor economic conditions of the 1990s will not be nearly as extreme as the Great Depression, the economy's response to monetary stimulus will be limited. Nevertheless, high interest rates would be an unnecessary hindrance to economic activity and must be eliminated. The disinflationary, even deflationary nature of the contained depression in conjunction with long-term counter-inflationary trends will erase inflation as a concern. (Section V)

Concept 3. The federal government can finance infrastructure investment in a manner that properly spreads the cost of a project over its useful life. Even under the present accounting system, expenditures for structures and equipment can be dealt with as investments. The scheme involves federal investments in projects through the purchase of below-market or no-interest bonds that must be repaid on a specified schedule. (Section VI)

The federal government's massive investment in winning World War II lifted the economy out of the Great Depression and set the stage for the succeeding decades of prosperity. Fortunately, our government has the opportunity to make large investments, not in machines of destruction but in facilities for enhancing the lives of its citizens, investments in a healthier environment, better transportation, and more effective education.

IV. MAINTAINING STRONG NATIONAL INVESTMENT DESPITE WEAKNESS IN PRIVATE CAPITAL OUTLAYS THROUGH EXPANDED PUBLIC INVESTMENT

The Need for Public Investment

The appeal of increased public investment in infrastructure in the 1990s is twofold. First, the economy needs a sound stimulus to help it through the contained depression, as has been discussed. Second, the nation must arrest the decay of its existing public infrastructure and begin making improvements to meet the demands of the next century.

The United States has a major need for infrastructure investment, some of it dire. Bridges threaten to collapse and occasionally do. Major city airports are seriously overcrowded, causing extensive delays for travelers. Many roads and highways are littered with dangerous potholes; others are antiquated and inadequate, resulting in chronic bottlenecks and further delays. Moreover, transportation is not the only area of need. More public investment would be prudent in water and waste disposal systems as well as other types of infrastructure.

Thanks to accidents, countless hours wasted, appointments missed, deliveries delayed, and other disruptions of business and consumer activities, Americans know that the infrastructure desperately requires improvement. These problems will get worse, and to solve them will

take years even if the country begins to address them immediately.

Some economists contend that the impact of public investment on private efficiency and competitiveness is great. Many, who have studied the issue, believe that America is already suffering substantial productivity losses because of the inadequacy of the infrastructure. While quantification of the relationship between investments in public fixed assets and private efficiency is a subject of controversy, many government-owned facilities clearly make positive contributions to the nation's product and quality of life. When a strike shuts down a public transportation system or a group of demonstrators obstruct road traffic, the importance of infrastructure to the production of goods and services becomes blatantly obvious.

Abundant evidence points to America's vast requirements for increased investment in infrastructure, yet data in this area are woefully inadequate. No one has made credible calculations of national needs and the costs of meeting them. Government should sponsor a national audit of infrastructure assets and needs. Based on the limited data available, The Jerome Levy Economic Institute's preliminary investigations conservatively indicate that an increase in current expenditures on infrastructure reaching $45 billion a year by the middle of the decade would be well invested. Further data might provide justification for a considerably larger sum (see appendix).

The following are tentative appraisals of the needs for increased investment in various kinds of public infrastructure, based on a variety of estimates from diverse sources:

* An increase in the annual investment in existing and new roads and bridges of $25 billion is warranted. Current expenditures are estimated at about $75 billion a year. The American Association of State Highway and Transportation Officials (AASHTO) finds that outlays for roads and bridges should increase by about $26 billion a year to maintain existing facilities and provide for future needs. Other organizations claim that a larger rise is needed.

* Conventional mass transit investment should rise to about $16 billion a year from $14 billion.

* Increases in outlays for high speed rail connections, "TGV" from France's pioneering *Train a Grande Vitesse*, should be about $2 billion a year. These modern trains can meet rising transportation needs and, at the same time, solve much of the problem of increasingly congested airports. TGV time between Washington and New York, for example, would be 100 minutes. Such high speed rail travel would relieve LaGuardia and National Airports of much of their congestion. France's experience is that the typical business traveler has switched to rail from air when he or she can reach the destination in less than three hours.

TGV is being constructed to link Houston, Dallas, and San Antonio. Considering the volume of travel and the inadequacy of airports, the United States would benefit from TGV links between New York and Boston and Washington, Chicago and Milwaukee and Cleveland, San Francisco and Los Angeles, to mention the more obvious.

* Government's annual investments in aviation facilities should increase by at least $1 billion. Ironically, although the airline industry is plagued with idle capacity, airport capacity is inadequate. Air transportation is still a growth industry. The Department of Transportation has proposed nearly doubling federal outlays for aviation, which were $2.6 billion in 1990.

* Outlays for waste water treatment should increase by about $3 billion. Sewerage disposal plants are often most needed by municipalities that have considerable difficulty in making these investments.

* Our studies have found few estimates of the needs for many other types of important infrastructure. Our belief is that they easily total $5 billion a year more than is being spent at present. Sizable funds should be spent for solid waste disposal, a problem intensifying in almost every community. Meanwhile, the needs grow for health care and education facilities, and for penitentiaries. In many areas, high priorities are given to soil and beach erosion and to water source development. Governments also need buildings such as fire stations and courthouses as a result of population growth.

Although governments are prone to inefficiency and waste, public construction almost always produces facilities that are fully used if

not overused. The United States government should not hesitate to increase investment in infrastructure by $45 billion or more annually. Such investments would be a major force for restoring economic growth, reducing unemployment, regaining control over the federal budget, and preparing the nation for the challenges of the twenty-first century.

Education, A Crucial Investment

A half-century ago or earlier, a national economy had a great advantage if it was rich in natural resources. Increasingly, a requisite for productivity and a high standard of living is a well-educated labor force.

The contained depression has increased the numbers of schools that have grossly inadequate faculties, supplies, and equipment. Expenditures to rescue young people from such handicaps are an investment, a vital one for the future of the economy.

The United States needs educated, productive people who can lead industries that exploit the latest technology and execute complex tasks efficiently even more than it requires better infrastructure. However, the technique for financing infrastructure investment proposed in this document (and detailed in section VI) is appropriate only for tangible, fixed assets that can be depreciated and their costs amortized in a businesslike manner. While education is a vital form of investment, except for school buildings and facilities, education expenditures are not suitable for this program—the timing, recipients, and size of the benefits are unclear. Nevertheless, effectively educating America's children is a top national priority and must not be neglected.

V. MONETARY POLICY FOR A DEPRESSED, NON-INFLATIONARY ECONOMY

The Overwhelming Case For Lower Interest Rates

A critical part of any effective program to cope with the economic challenges of the 1990s will be to redirect monetary policy from fighting inflation to promoting stability and growth. Interest rates no higher than those that prevailed three decades ago are a necessity. From 1957 to 1965, yields averaged 3.0% on three-month Treasury bills, 4.0% on ten-year U.S. bonds. Real gross national product expanded at an average annual rate of 3.8% and consumer prices rose less than 1.5% a year.

Still lower interest rates will have some positive, although limited, influence on growth. They will promote private as well as state and local government investment, encourage businesses to take a longer-term view, ease debt-service burdens (and therefore pressures on the financial system), and shift purchasing power from passive income recipients to active workers.

Moreover, lower interest rates mean a lower cost of financing the national debt. The major role of government interest payments in widening the deficit will be increasingly important as the 1990s progress regardless of what economic program the government institutes (see section VII).

Easier Monetary Policy/Lower Interest Rates Will Not Cause Inflation

Aggressive reduction of interest rates will *not* lead to an acceleration of inflation. The contained depression brings not only deflation of fixed asset prices but also disinflation and the threat of deflation for consumer goods and services prices. Under these circumstances, an easy money policy will not lead to accelerating inflation.

As the Great Depression reminds us, neither low interest rates nor rapid growth of the money stock necessarily leads to inflation. For example, from 1932, the worst year of the slump, to 1939, when war in Europe was beginning to restore prosperity, low interest rates and rapid money stock growth produced no inflation. During that seven year period, three-month Treasury bill rates were under 0.5% except on rare occasions and at times they were actually negative. Money stock (demand deposits and currency outside banks) expanded at an average annual rate of 8.5%. (If time deposits are included in money stock, it grew at the rate of 5.1% a year.) And the consumer price index rose at an annual rate of less than 0.3%.

Even when the current, contained depression ends, a revival of inflation is unlikely. Whether a real improvement in the economy occurs relatively soon as a result of government measures, or it is delayed for several years until present excesses in capacity and debt have di-

minished, prosperity will probably come without much inflation. The reasons are changing domestic employment markets and increasingly powerful, counter-inflationary international influences.

Labor market inflation is on the wane. The decline in wage raises for hourly paid workers and shrinking salary increases are major trends that will continue for years. Workers at all levels will learn that if their companies cannot be competitive, they may lose not just their present jobs but their careers. As industries downsize, many displaced employees will find that there is not much of a market for the skills and experience that they have accumulated over years, so they may have to switch careers and accept lower incomes. The contained depression is bringing a revived emphasis on worker productivity, cost containment, and competitiveness that will not easily yield to a new wage-price spiral.

Meanwhile, the trend toward economic globalization is a permanent and increasingly important, downward pressure on the compensations of American workers. The competitive advantages of labor forces in lower-wage, newly industrializing nations are increasing. Vast strides in communications, computer, and transportation technologies make it possible and competitively necessary for companies in the United States and other high-wage nations to transfer operations to low-wage countries. Formerly, firms reduced only manufacturing costs by taking advantage of low compensation rates for foreign labor. Now clerical functions, computer programming, design, and engineering are moving to India, Ireland, Mexico, Taiwan, as well as to other distant places. The collapse of the Soviet empire has added a vast supply of well-educated, extremely low-paid scientists, engineers, and technicians to the global labor force to say nothing of the millions with less sophisticated skills.

American economic culture has been reestablishing the link between compensation and productivity, an association that was clearly present between 1958 and 1965 but began to deteriorate when escalation of the Vietnam War started to overheat an already prosperous economy in 1966. When prices soared in the 1970s, wage negotiations emphasized "keeping pace with inflation." The relation between compensation and productivity was forgotten. This connection is a major prerequisite for stable labor costs that will not be easy to forget in the 1990s and beyond.

VI. FINANCING PUBLIC INVESTMENT: A RATIONAL METHOD WITHIN THE IRRATIONAL FEDERAL ACCOUNTING SYSTEM

Expenses vs. Investment

Investments are investments; expenses are expenses. Yet under present practices, the federal government makes no distinction as to whether funds are used for *investing* in dams, highways, or computers or for such current *expenses* as transfer payments, employee compensation, or interest on the debt. Therefore, government investment that is financed through borrowing is treated as if it were deficit spending—a practice no more logical than asserting that a person who spends $200,000 buying a house becomes $200,000 poorer.

In the present era of inevitably large government deficits and a widespread reluctance to borrow more than necessary, the inability to distinguish between investments and expenses leads to gross distortions of national priorities. The convoluted perspective created by the federal accounting system is having a disastrous effect both on short-term fiscal management and on long-term development of the nation's public assets. Government denies the economy needed fiscal stimulus; too much of the stimulus it does provide is consumed without creating assets of lasting value; and public infrastructure and other long-term interests are neglected.

One way or another, policymakers will ultimately have to recognize that investment is investment, not expense. The arguments for the creation of a federal capital budget will gain support in the years ahead as changes in the national accounts (GNP, GDP, etc.) alter the way economists and other observers view the government's accounts. The national accounts, which are not used for budget purposes, are already moving toward a separation of capital and operating accounts. The Bureau of Economic Analysis has begun a multi-year transition, which has become part of the Chairman of the President's Council of Economic Advisor's

"Statistical Initiative," to change from the familiar National Income and Product Accounts (which include GNP) to the System of National Accounts, which is the international standard with numerous advantages. The System of National Accounts *will* separate the federal government's investments in structures and durable goods from its expenses.

Nevertheless, no matter how glaring the flaws of the present accounting system used for federal budgeting, the system will not be transformed instantly, and whether it can be changed even after a long, drawn-out political debate is questionable. Therefore, the program outlined in this document relies on a financing technique that will enable the federal government to amortize investment over multi-year periods even under the current accounting system.

Section II explained that the contained depression will assure rapid growth in the amount of outstanding federal debt during the 1990s. The question is: how much of that debt will finance investment in assets of lasting value, and how much will be spent on consumption? If the American people are truly concerned about projections of how much debt their children and grandchildren will have to bear, they will not pursue self-defeating, destructive austerity programs but instead make sure that those children and grandchildren inherit assets along with their debt: a transportation system that works, safe and reliable water supplies, well-equipped schools, environmentally sound sewerage disposal systems, and so forth.

A Financing Technique for Federal Investment in Infrastructure

The federal government needs to spread the cost of an investment over its useful life, instead of immediately charging it off completely as an expense. By organizing projects appropriately and by employing a simple financing technique, the government can achieve this goal while conducting its investment spending in a sound, businesslike manner. The following steps are required:

1. The project must be under the auspices of an explicit entity separate from the federal government such as a state, city, sewer district, or a public enterprise such as the New York Port Authority.

2. All projects must involve the creation of tangible fixed capital—structures and durable equipment with useful lives that can be reasonably well estimated.

3. The Treasury will lend money to finance projects through the purchase of bonds issued by the responsible jurisdictions. The debt will be amortized with a repayment schedule that matches the expected useful life of the investment.

4. The project will have an explicit plan for generating revenue for repaying the debt—user fees, tax revenues from the regional governments whose constituents will benefit from the project, etc.

5. The Treasury will finance 80% of any project; the private sector must finance the rest. The private investors will have an *equal*—not preferred—claim to that of the Treasury on the revenues of the project. To assure the soundness of the Treasury's investments, provisions will prevent the private sector investors from receiving "junk bond" interest rates.

6. The Treasury will collect interest on the bonds at below-market rates or 0 percent. The 20% financing from the private sector investors will, of course, yield a market rate.

7. Initially the program will finance most major state and local government investments in a fixed assets in accordance with the above provisos. However, some types of projects would be excluded. The Treasury should probably not, for example, invest in publicly owned stadiums used predominantly for professional sports. As the need for federal investment changes, the list of eligible types of projects should be revised in accordance with national priorities.

8. The covenants between the authority borrowing funds for a project and the Treasury and private lenders will stipulate, wherever applicable, that the new facility be properly maintained.

A large-scale infrastructure program to meet American transportation, environmental, and other needs would employ large numbers of people. This expanding demand for workers might lead to wage inflation in construction. In order to encourage pay rates that are a fair market measure of employees' skills, responsibilities, and other attributes, the government should consider modifications of the Davis-Bacon Act.

This law, adopted in 1931 to help assure that construction workers would receive reasonable wages, is often accused of assuring unreasonably high costs on federal projects.

This financing procedure would not require the creation of a large bureaucracy. Quite the contrary. The Treasury would not have to evaluate the worthiness or soundness of each project. The voters or their representatives in each jurisdiction would decide whether the cost to them is worthwhile. The private investors would evaluate the soundness of the investment.

Most of the work involved in administering the program could therefore be carried on by the private sector banking institutions that would be involved in any conventional financing of municipal projects. The cost would be small. To keep it down, stipulations and adequate oversight should be effected to limit fees and other charges for the services provided by these private sector firms.

Of paramount importance in this procedure is that the federal government does not incur an expense when it invests in infrastructure. The Treasury is merely buying infrastructure project bonds and selling its own securities—rearranging its financial balance sheet but not spending on goods or services. The outflows of cash would be loans, not purchases, loans that would be paid back in full.

What would affect the budget would be the negative interest spread each year, the difference between what the Treasury pays to borrow and what it earns (if anything) on infrastructure bonds. That negative spread would be the federal subsidization of the project. The subsidy, the cost to the taxpayers, would be spread out over the life of the project as it should be. Thus, the federal government could invest in infrastructure without the entire investment appearing on its budget as an expense in the year it was made.

This procedure would slash financing costs, which are major parts of the total costs of most projects, and it would stimulate a great deal of public infrastructure investment. There would be two controls to assure the soundness of projects financed under this program. One would be the willingness of voters to assume the future financial commitments, which would be significant even if subsidized. The other would be the private investors who would know that if their bonds defaulted, they would lose just as much on every dollar invested as would the Treasury.

In the past, unconventional federal fiscal activities have been criticized as "smoke and mirrors," tricks to increase deficit spending. This program is not vulnerable to such complaints. The result of the proposed financing techinique is to make federal spending *more* businesslike. The concept of amortizing investment spending is basic to GAAP and employed by every corporation in America. State and local governments recognize the distinction between investment and expense when they issue bonds to finance a college dormitory or a fire house and amortize these debts. The proposed use of bond financing merely adjusts for the distortions created by the federal accounting system. No one could use this program for transfer payments or mislabeled investments with vague or intangible benefits.

Public Investment Through State and Local Governments

Subsidized federal financing of state and local infrastructure projects would have a number of features that warrant mention. It would have two advantages over a direct federal investment:

1. Planning is decentralized. Decisions are made by people close to the situation, and, in many cases, through referenda.

2. Mobilizing the investment effort is faster. Small local projects may be started faster than large federal ones. Also, many local or regional projects have been studied and are more or less ready to be started once funding is found. The faster America increases public investment, the better for the economy.

The merits of stimulating public investment in infrastructure during the 1990s have already been discussed, but there is another argument for federal subsidization of state and local projects. They are often in the interest of the entire nation. For example, the benefits of a new school building in a community are enjoyed by the families with children. But the interests of *all* members of the national community are served by better school facilities, because the educational attainments of the future work force will affect the country's standard of living.

It is worth noting that the federal government already subsidizes state and local infra-

structure by granting tax-exempt status to interest on municipal bonds for public construction projects. This subsidy is considerably less than it was several years ago before the federal corporate tax rate declined from 46% to 34%. The proposed plan would be conceptually similar to the current tax exemption of state and municipal bonds, but would provide the finance-cost subsidy more directly and offer a larger subsidy.

VII. THE DEFICIT DILEMMA AND HOW TO BEAT IT

A New, Long-Term Strategy For Deficit Reduction

Were the national debt and its concomitant interest cost to increase relative to gross domestic product indefinitely, the United States would sink into a fiscal morass that would imperil its entire economy. Government must assure that deficits and the debt do not achieve a "critical mass" that would put them beyond containment.

Fiscal policy in the late 1980s and early 1990s has been dominated by the belief that the federal deficit is primarily a cause of economic problems, not a symptom. By describing a large part of the deficit as "structural," this notion that the deficit is independent of any outside causes other than poor fiscal management has been given a false validity. In fact, estimates of the structural deficit are based on estimates of the nation's potential output, income, and profit flows that in turn rest heavily on conjecture and on simplistic assumptions about wages and salaries, profit margins, interest rates, productivity, and so forth. Just as the "natural rate of unemployment" has been cited at anywhere from 3% to 6%, the structural deficit is a subjective quantity.

Since the mid 1980s, government has focused its deficit reduction efforts on spending cuts and tax increases. This approach was doomed to fail, as evidenced by the results of Gramm-Rudman-Hollings I, GRH II, and the 1990 budget accord. Undoubtedly, many of the budget projections during these years were purposely given a rosy hue in order to create the appearance of conforming to the GRH targets. Nevertheless, again and again most involved public officials and private sector observers were stunned by the huge gaps between the actual and projected deficits.

The two biggest reasons for our current deficit are not congressional or executive spending and tax actions; rather, they are the contained depression and high interest rates. This statement implies nothing about the efficiency or wisdom of past government expenditures. Whether the government spends wisely or not is of course important for the quality of life, fairness, and the long-term strength of the nation; however, the quantity rather than quality of federal spending influences the size of the federal deficit.

Over a period of years, economic conditions generally have more influence on the size of the deficit than does fiscal policy. On one hand, a vigorous economy will generate strong income. Even if a large deficit is created through, for instance, a tax cut, the economy will tend to expand so rapidly that higher income will offset the lower tax rates and shrink that deficit. On the other hand, during the contained depression, the economy generates less income and therefore less tax revenue and requires larger transfer payments, causing a deficit that will swell until it provides enough economic stimulus to arrest the economic decline. Under these conditions, attempts to trim the deficit are self-defeating; they cause further economic decline, and further reductions in tax revenues.

Thus, weakness in the private economy, which was aggravated by high interest rates, has thwarted efforts to achieve deficit reduction through "belt-tightening." *A superior strategy for deficit reduction is to expand revenues through economic growth and to limit expenditures through interest rate decreases.*

A proposal to raise revenues by stimulating growth understandably raises suspicions based on the great deficits that followed the tax cuts early in the 1980s. There are four responses to this concern:

1. Fiscal stimulus is not inconsistent with narrowing deficits. Toward the end of fiscal 1964, a year in which the federal deficit was $5.9 billion, Congress passed an $11.5 billion tax reduction (equivalent to about $100 billion if scaled to the present size of the economy). In fiscal 1965, the deficit dropped to $1.4 billion, when revenues increased and outlays remained the same. A rising deficit in the following years

reflected soaring Vietnam War costs, not the 1964 tax cut.

Tax cuts have generally been followed by higher revenues, even after adjusting for inflation. However, the reasons for these favorable developments are complex, and we are not arguing that lowering taxes is the way to reduce federal red ink. We are emphasizing that tax reductions, especially during recessionary periods, do not necessarily widen deficits.

2. In the 1980s, because of the excessive foreign exchange value of the dollar and America's deteriorating competitive position, the tax cuts stimulated a great deal of consumption of foreign goods, which raised income and therefore tax revenues in other countries instead of at home. With policies that keep interest rates low and the dollar's value in a competitive range, the present, gradual trend toward a more favorable trade balance will continue. The risk of a swelling trade deficit similar to that of the early and middle 1980s is slight.

3. The proposed program will have a focused, domestic impact. Considerable portions of tax cuts may be spent on imported goods; the initial impact of investments on public construction, on the other hand, is almost entirely domestic.

4. The 1990s situation has a special dimension: to the extent that a fiscal stimulus moderates economic problems, it prevents bankruptcies, bank failures, and additions to the national debt associated with payments to the Federal Deposit Insurance Corporation and the Resolution Trust Corporation.

Over time, growth-oriented programs based on public investment can shrink the deficit, especially as a share of GNP. Interest payments on the debt can actually fall even though the debt is still growing as, indeed, has already begun to occur. Meanwhile, the nation can attend to its long-term needs and avoid the costs of austerity.

Managing the National Debt

Many Americans are alarmed over the sheer size of the national debt and might worry about the country's ability to service it even if debt growth reflected the financing of worthwhile, valuable assets. Some have argued that the nation is heading toward a devastating crisis involving either massive default or hyperinflation. The seeming intractability of huge deficits portends, they assert, further, rapid rises in the national debt until it is indeed out of control.

They are wrong. America is not in danger of such a crisis.

At end of fiscal 1946, the net debt of the United States Government was $242 billion, 117% as large as gross national product. By this gauge, the midyear 1991 debt, 47% as large as GNP, was hardly burdensome.

The federal debt will continue to increase during the contained depression, but it will certainly not grow to be 117% of GNP. Under extremely pessimistic assumptions which include a continuation of the contained depression to the year 2000, the debt/GNP ratio would not reach 100%.

The contained depression will give way to an era of robust fixed investment and rapid growth. After several years of downsizing, retrenchment, and reorganizations, the commercial, industrial, and financial sectors will be on the road to good health. Excess capacity in many industries will have shrunk, population growth will be accelerating, new technologies will be awaiting implementation, and the result will be a surge in new private investment. The nation will prosper again; tax payments will expand considerably; and the federal deficit will decrease, even vanish. The debt/GNP ratio will fall.

Although the size of the national debt is not in and of itself a reason for alarm, the cost of servicing that debt is another matter. Interest expenses are the real burden of the debt. Back in 1946, rates were so low that even the enormous debt required federal payments only 1.9% as large as GNP. At mid-1991, the corresponding figure was 3.4% This percentage would increase sharply reflecting the growth of the federal debt during the contained depression if rates remained constant.

Fortunately, rates will continue to fall. Indeed, the need to ease the burden of government interest obligations is one of the compelling reasons for further slashing interest rates. If rates fall to or below their early 1960s levels, as recommended above, the interest burden relative to GNP will be smaller in 2000 than it is today.

VIII. MATCHING POLICY TO ECONOMIC NEEDS IN A TIMELY FASHION

A Transition Program

The overall program outlined in this document is designed to improve economic health over the coming years and beyond. However, public investment policy cannot be turned on with the flick of a fiscal switch. What can the government do right now to stabilize the economy and improve the employment situation?

First, the state and local subsidized infrastructure finance program should begin immediately. While new projects cannot begin instantly, some projects have been planned but delayed and others face cancellation because of state and local fiscal crises. Making money available now could change the number of projects that will be underway in the months ahead.

Still, more is needed: actions that can have an almost immediate, favorable impact on the economy. One of the most obvious, and proven, is to reduce withholding taxes. Another is providing grants to states to meet current expenditures.

Lowering withheld federal income or social security taxes would produce a direct, potent fiscal stimulus. People with middle and low incomes are most inclined to spend additional take-home pay, so the lion's share of any tax cut should be directed to households in these income brackets. While it is true that some consumers would not spend much of their increased take-home pay, instead paying off debts or enlarging cash balances, others would increase spending more than the tax cut by applying their increased disposable income to monthly payments on major purchases.

At a time when many state and local governments are reeling from their own fiscal crises and taking extreme steps to balance budgets, federal revenue sharing could prevent employment and service cutbacks. Such a program could bring rapid relief to school programs where recent or prospective budget reductions threaten to undermine already inadequate investments in the future productivity of the nation's children.

Education should remain a strategic priority for federal spending, as stressed in section IV, but tax cuts or non-investment expenditure increases should be regarded as emergency measures—supplementary, economic stimulants to be used only as needed. Such actions to stimulate the economy should be legislated for a year at a time so that they could be phased out as public infrastructure investment expands.

How Much Stimulus Does the Economy Need?

This program is designed to maximize the containment of the depression and to attend to the nation's long-term interests. It does not promise to keep the economy at full employment or smooth all the bumps along the economy's growth path. Selecting the correct fiscal stimulus to counter inventory recessions is hard enough. When the economy's performance is complicated by bursting speculative bubbles, unpredictable crises in the financial sector, and global economic instability, the job becomes more problematic.

Nevertheless, some guidelines can be offered:

1. The probability of overheating the economy during at least the next five years is extremely low. The chances are that new policies to stimulate growth will be insufficient rather than excessive.

2. National investment should be pursued vigorously in order to end the contained depression and establish the basis for long-term prosperity. The federal government should meet whatever demand arises from state and local governments for subsidized loans until the economy shows signs not merely of growth but of a return to financial health and strong private investment.

3. The government must continually monitor the situation. When the economy shows signs of decline, additional stimulative measures may have to be considered. Federally financed public investment should be the preferred vehicle for invigorating the economy.

4. If and when the stimulus of national investment does prove greater than desired, the government can enact tax increases or other fiscal restraints to prevent straining productive capacity. This contingency will not arise during the next few years and it may not become a

legitimate concern until years after the contained depression.

5. When the contained depression ends, the ensuing, healthy investment boom is likely to be noninflationary. Global competition and widespread implementation of productive new technologies likely will be long-term, counter-inflationary forces.

Global Complications

How can the government keep the stimulus of public investment in the United States? Will stimulating the domestic economy lead consumers, businesses, and even governments to purchase more foreign goods, thereby widening the trade deficit and increasing foreign debt?

The government can limit but not suppress these effects. The United States should exhort other industrialized nations to join it in promoting growth and stability. Low interest rates will help by tending to depress the dollar and, therefore, to discourage imports and encourage exports.

Of course any improvement in the U.S. economy, whether caused by the proposed program, another, or an autonomous revitalization of the private economy will tend to worsen the balance of trade. Likewise, any strengthening of foreign economies will have a favorable effect on U.S. trade. Certainly government should not forfeit prosperity because of the globalization of the economy.

IX. CONCLUSION

The vexing nature of the present recession, unprecedented in modern history, is a reflection of profound problems that will take years to overcome. It is time to face up to the realities of the situation and to take bold action. Government has both the obligation and the ability to spare the American people unnecessary pain and heartbreak and to build a foundation for prosperity in the next century.

The nation has no choice between big deficits and belt-tightening. Belt-tightening as a means of deficit reduction will backfire and cause enormous damage at the same time. The real choice in the 1990s is between big deficits and a gradual replacement of big deficits with national investment.

America needs to have a vision for the next century and then work to achieve it. Private investment will remain at best lethargic for several years. Government can help create an environment that will hasten the development of new technologies and capabilities that will restore the vibrancy of private investment and make American business robust and competitive. And government can certainly finance a better infrastructure that will enhance the quality of life and promote efficiency.

APPENDIX

INFRASTRUCTURE NEEDS: PARTIAL BIBLIOGRAPHY AND SOURCE LIST

American Association of State Highway and Transportation Officials, The Bottom Line: A Summary of Surface Transportation Investment Requirements, 1988-2020, September 1988.

American Association of State Highway and Transportation Officials, A Federal Surface Transportation Program for the Future, 1991.

American Federation of Labor & Congress of Industrial Organizations, Information packet on the Davis-Bacon Act.

American Public Transportation Association, Transit Fact Book, September 1990.

American Road & Transportation Builders Association, An Analysis of the Bush Administration Proposal for Reauthorization of the Federal-Aid Highway & Mass Transit Programs, February 1991.

Associated General Contractors of America, "United States Infrastructure Facts", August 1991.

Association of State and Interstate Water Pollution Control Administrators, "Municipal Needs Assessment 1991".

Congressional Budget Office, An Analysis of the President's Budgetary Proposals for Fiscal Year 1992, March 1991.

Congressional Budget Office, How Federal Spending for Infrastructure and Other Public Investments Affects the Economy, July 1991.

Congressional Budget Office, "Lessons from the Past, Opportunities for the Future: The Changing Role of Public Investment in Economic Growth", remarks to the Colloquium on the Nation's Infrastructure Policy, November 17, 1989, by W. David Montgomery, Michael D. Deich and Elizabeth A. Pinkston.

Congressional Budget Office, New Directions for the Nation's Public Works, September 1988.

Defense Base Closure and Realignment Commission, Report to the President, July 1991.

Denver International Airport, Airport Public Affairs, Stapleton Terminal Building — 3199, Denver, CO 80207, (303) 270-1250.

Federal Highway Administration, The 1991 Status of the Nation's Highways and Bridges: Conditions, Performance and Capital Investment Requirements, July 2, 1991.

General Accounting Office, The Davis-Bacon Act Should Be Repealed, April 27, 1979.

Goldfarb, Robert S. and Morrall, John F., "The Davis-Bacon Act: An Appraisal of Recent Studies", Industrial and Labor Relations Review (Cornell University), Vol. 34, No. 2 (January 1981), pp. 191-206.

Munnell, Alicia H., Is There a Shortfall in Public Capital Investment?, The Federal Reserve Bank of Boston, June 1990.

National Council on Public Works Improvement, Fragile Foundations: A Report on America's Public Works, February 1988.

Office of Technology Assessment, Delivering the Goods: Public Works Technologies, Management and Financing, April 1991.

Peterson, George E. (The Urban Institute), "Historical Perspectives on Infrastructure: How Did We Get Where We Are?", delivered at the American Enterprise Institute conference on "Infrastructure Needs and Policy Options for the 1990s", February 4, 1991.

Rail Transport Systems Inc., 2990 Brandywine Road N.W. - Suite 125, Atlanta, GA 30341, (404) 452-8001.

Texas TGV/Morrison Knudsen Corporation, 600 Congress Avenue, Suite 1630, Austin, Texas 78701, (512) 472-7491.

Thieblot, Armand J. Jr., The Davis-Bacon Act, University of Pennsylvania, Wharton Industrial Research Unit, 1975.

Transportation Counselor, French Embassy, 4101 Reservoir Road, N.W., Washington, DC 20007-2179, (212) 944-6095.