The Economic Challenges of the Next Four Years

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During President Clinton's first term, it is expected that a national industrial and planning policy will be adopted. More government regulation, more taxes for those in the upper brackets, and more spending programs are expected as well.
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Thank you for the implicit confidence you have shown me, by assigning me the daunting task of figuring out what course President Clinton's new administration will follow.

There is always a substantial gap between initial promises and ultimate performance. That surely has been in the case of every recent U.S. president. Nevertheless, a new president and one from a different party will surely bring about important changes in American policy and in public attitudes.

It is useful to start with a baseline— an overview of the U.S. economy. The end of the presidential campaign has cleared the air. It is no longer necessary for Republican economists to boast of a speedy recovery. Nor is it fashionable for Democratic economists to continue to lament the rapid decline of the American economy.

In fact, economic chroniclers have recently told us that the recession ended a year-and-a-half ago. That must be one of the best kept secrets of the decade. The newest University of Michigan survey reports, "For the first time in five years, more consumers reported hearing news of favorable rather than unfavorable developments in the national economy." If any economic journalists take that as an indictment of the working press, so be it.

What does seem to be in store is a steadily growing economy in 1993, one that is expanding at about 3 percent. Although modest for the early stage of a recovery, a relatively slow growth rate has some beneficial side effects. The most notable are low inflationary pressures (also about 3 percent for the year ahead) and limited expectations for rising interest rates.

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The existing momentum (or lack of it) in many sectors of the economy will continue to be a dampening influence. The glut of commercial and office buildings prevents an upturn in this type of construction no matter how expansionary monetary and fiscal policy may be in 1993. Similarly, a prolonged decline in defense production is in progress and changes by the new team may only accelerate that downward trend.

Despite the welcome upturn in consumer confidence, households do not set the pace for economic recoveries. That is especially likely to be the case this year because of the limited prospects for growth in personal income. This puts the main hope for economic acceleration on business investment, especially in equipment. With overall industrial capacity utilization below 80 percent, not too much can be expected from this sector. The long-term utilization average (1967-1991) is 82 percent.

The slowdown or downturn in much of the rest of the world is having a dampening effect on our own economic expansion. This will limit the automatic or painless reduction in the budget deficit.

In any event, President Clinton is likely to enjoy an extended economic honeymoon. Given the large amount of slack in the economies of the United States and most of our major trading partners, any new round of inflation will probably be very slow in developing. The other side of that proposition is that, once inflation gets going, it is very painful to bring it down.

Clintonomics

The general dimensions of the changes that we can expect in the next four years seem to be fairly clear. The Clinton Administration will promote a far more activist government role in the economy.

The announcement of a new and young political team in the White House with an ambitious program has already helped to generate renewal of consumer confidence and even business confidence. Also, the delayed effect of the monetary easing by the Federal Reserve last year is stimulating economic activity.
To some extent, Americans held off buying "big ticket items," such as automobiles, appliances, and home furnishings — and especially new homes. With less uncertainty at least in the political sphere, consumers are beginning to open their wallets and purses once again. Simultaneously, and despite philosophical misgivings, many in the business community are also welcoming the renewed growth of governmental subsidies to and markets for private enterprise.

Let us analyze the key policy issues that are likely to arise and the actions that will be taken in the Clinton Administration over the next four years. In the short run, it now seems clear that the new White House will focus on getting the American economy to grow faster. The new administration is developing proposals to spend more federal money and to cut taxes. That's no surprise. But the details are an innovation. Rather than entitlements, we will hear more about public investment.

Infrastructure

Expenditures for federal public works will be expanded substantially. Proponents now call that investment or infrastructure development. Candidate Clinton promised to create a "Rebuild America Fund" to finance a great variety of infrastructure projects and to jump start a slow-growing economy.

This variation of an old-fashioned jobs program covers far more than merely repairing roads and bridges. It includes a high-speed rail network linking major cities and commercial hubs, developing "smart" highway technology, generating new energy sources, creating advanced recycling systems, and building a national information network linking every home, office, factory, library, laboratory, and school.

It is unlikely that President Clinton will be able to move on all of these fronts at once. But we can expect that his administration will make the effort in the case of many of them. The growing availability of scientists and engineers laid off by defense contractors constitutes a
great pressure to utilize this valuable resource through these types of federally initiated programs which were proposed during the campaign.

How will the ambitious array of infrastructure projects be financed in a period of continuing large budget deficits? Tax increases, never popular, are already pledged to reduce the deficit — and to finance a middle class tax cut. Hitting "the rich" won't raise enough to do that, much less pay for new spending programs.

During the campaign, Candidate Clinton proposed to tap private and state and local pension funds to finance infrastructure. At my age, I am not very happy at the prospect of seeing my retirement money diverted to political schemes. But, far more important, these funds are already invested — heavily in corporate stocks and bonds. Thus, if the President succeeds, this will mean pulling investment capital out of business in the private sector and moving it to government agencies in the public sector. Whether or not you like that shift in priorities, it is not a net addition to the total investment of the American economy.

Tax Proposals

On the tax front, several challenges face President Clinton and Secretary of the Treasury Lloyd Bentsen. They have to increase revenues and do it in a way that doesn't weaken the economy too badly. That's an important balancing act because a weak economy does not bring in as much revenue as a strong economy. For example, increasing the tax burden on the high-saving upper bracket and corporate taxpayers will reduce private saving, which is the basic source of financing private investment. To be sure, some rich people dodge the tax collector because they can hire high-priced lawyers and accountants to find them loopholes to shelter their income from taxation. Of course, raising the rates will give them more incentive to do just that.

Yet, the overall numbers are an eye opener. The households in the top fifth of the income distribution pay out about 27 percent of their incomes in federal taxes. The households in the middle fifth pay 20 percent of their income in federal taxes. The bottom fifth pay only 9
percent of their income in federal taxes. A full third of all federal tax payments is collected from the top 5 percent of households.

To offset the anti-investment effect of personal income tax increases, we will probably see the investment tax credit reinstated. It likely will be on an incremental basis. That is, a credit will be given for, say, 10 percent of the amount that equipment investment in 1993 exceeds 80 percent of last year's investment. As someone who has been urging the reinstatement of the investment tax credit for over a year now, it's hard for me to quarrel with this part of Clintonomics.

But Congress often takes the initiative in the tax area. The odds are that members of the Congress in both parties will initiate serious hearings on a consumption tax some time later this year. Informal discussions on this topic have been underway in Washington for about a year now.

I do not mean a national sales tax. The dominant U.S. proposal is not for a European style value-added tax. Rather, interest is rising in changing the present income tax to exempt all saving. The result could be as progressive a rate structure as at present, but with more incentive for saving and investment and thus make more likely a faster rate of economic growth and of job creation.

Health Care Reform

The rapid rise in health care costs plus the decline in health insurance coverage is forcing action in this area. The new Congressional Budget Office study is compelling. On the basis of merely continuing current policy, CBO expects that health care outlays in the United States will rise from 14 percent of the GDP in 1992 to 18 percent in the year 2000.

Mr. Clinton is not satisfied with the status quo. During the campaign, he pledged to guarantee every American quality health care. His "core" package includes hospital care, physician services, prescription drugs, prenatal care, mental health, mammograms, and routine
screening. He also advocated expanding Medicare to cover long-term care. All that will be very expensive and is likely to be phased in gradually.

Candidate Clinton also wanted to establish new health agencies, including a national health standards board and local health networks. The board is to be charged with establishing health budget targets and determining the specific contents of the package of core benefits that is to be made available to every American. The unwieldy board will be made up of consumers, health care providers, business, labor, and government officials. Have you ever tried to get a tripartite group to make a tough decision? How about a five-part board? If it works, the designer deserves a Nobel prize in economics. A task force is trying to flesh this out right now.

Candidate Clinton also envisioned a variety of local health networks made up of hospitals, clinics, doctors, and insurers. Like the present health management organizations (HMOs), each network will receive a fixed amount of money for each patient. That is expected to give them the necessary incentive — and ability — to control costs. Incentive, yes. Ability, that's an open question.

Every employer would be required either to buy private health insurance for its employees or to pay into a public fund created for the purpose. Every American not covered by an employer is to receive the core benefits package. There is no indication who will pay for that. Clearly, Congress will treat whatever proposals the administration will send up as only an initial draft. But major changes in health policies seem likely in this administration.

Education

The concern over the poor showing of U.S. high school students in international tests reenforces the desire to develop a positive response to the competitiveness challenge. That high road is to focus on education and training instead of protectionism. Moreover, education and training is a special interest of Robert Reich, the new Secretary of Labor. During the campaign, Mr. Clinton surfaced some expensive plans to "overhaul" the public schools. That
includes establishing tough education standards, setting up a national examination system, and reducing class sizes.

The easiest part is to provide money for school security and metal detectors. Candidate Clinton also advocated setting up a new fund to loan money to every American who wants to go to college.

For those who do not go on to college, he urged setting up a Youth Opportunity Corps and establishing a national apprenticeship system. During the campaign, he promised each graduate “a good job.” That’s one of those campaign pledges that is likely to be quickly forgotten.

After examining the many technical difficulties involved, the Clinton people are soft-pedalling his promise to require every employer to spend 1.5 percent of payroll for education and training. Many companies, especially the larger ones, already do that. The current expectation is that any federal directive will be voluntary or restricted to the larger firms.

Social Programs

Social welfare outlays, while growing, do not seem to be a front burner issue. But I suspect that Donna Shalala, the new Secretary of Health and Human Services, will try to carry through on the campaign promise to fully fund Head Start, the infants and children program, and all of the other initiatives proposed by the National Commission on Children. This approach also includes giving people on welfare both education and child care — in an effort eventually to wean them off public support. If successful, this means that welfare spending will rise more rapidly before it declines.

In addition, President Clinton has advocated a national databank on parents that don’t support their children. He also wants to use the Internal Revenue Service to collect child support from recalcitrant parents. As a Treasury alumnus, I have great confidence in the ability of the IRS. But I have to point out that, in the absence of a major budget increase, new responsibilities are performed at the expense of existing activities such as collecting taxes.
Housing and Urban Development

The government's role in housing is also a candidate for growth. Candidate Clinton's plans included government funding of low-income housing and creating a network of community development banks. The latter sounds suspiciously like the original justification for the now failed savings-and-loan associations. It is likely that Henry Cisneros, the new Secretary of HUD, will try to focus national attention on the problems of the inner cities.

Regulation

The easiest forecast to make is that government regulation of business will be on a growth trajectory. Actually, it already is. A further expansion is likely. The environmental area, championed by Vice President Al Gore, is a natural. The new head of EPA is a protege of the Vice President.

The acceleration of an already rising trend has been fanned by partisan political charges that the Bush Administration cut back on regulation of business, especially in the environmental area.

Yes, it is true that, on occasion, George Bush and, especially Dan Quayle, delayed or caused to be modified some of the most costly and inefficient regulations that were proposed by the federal regulators. But every president since Gerald Ford, and that includes Jimmy Carter, has found the need to set up a regulatory review mechanism in the White House.

Despite all that, environmental regulation accelerated during the past four years. That is true any way that you measure it — by the number of regulators, by the EPA budget, by the number of pages in that bible of regulation, The Federal Register, or by the cost of compliance in the private sector.

It is ironic that, during the Earth Summit in Rio last June, the nations that criticized the U.S. position all have weaker environmental laws and enforcement procedures and devote smaller shares of their economy (e.g., gross domestic product or GDP) on environmental cleanup than we do. In automobile regulation, for example, the big debate among the
Europeans is whether they will ever match tougher U.S. standards. Even if they eventually do, there will be many years of delay on their part.

Already in the congressional pipeline are bills to reauthorize and expand the Clean Water Act and the laws governing the disposal of hazardous wastes.

State and Local Relations

In the next four years, the federal government may be entering areas of activity traditionally reserved to state and local governments and to the private sector. For example, candidate Clinton promised to create a National Police Corps. He also pledged to put 100,000 new police officers on the street and to establish boot camps for first offenders.

My forecast is that, as a practical matter, that will mean more federal grants-in-aid to state and local governments who will carry out any new initiatives that are enacted. As states and localities already point out with great dismay, those grants typically come with many strings attached. Also, the federal money becomes a carrot for shifting state and local budgets to meet federal priorities.

Privatization, in contrast, will be considered a form of pornography by the Clintonites. Very quietly, discussion of this topic is being dropped from polite public discourse. This demonstrates the ability of the President to set the tone of the national debate and to influence the composition of the public agenda.

Defense Conversion

The defense budget is likely to be cut more rapidly than had been planned by President Bush, but the federal government will be more heavily involved in the activities of defense companies. Thus, Mr. Clinton has proposed a new program of loans and grants to help defense companies convert to civilian pursuits. His infrastructure programs specify the use of defense production facilities.

Given the past inability of defense contractors, especially the larger firms, to use their capabilities in civilian markets, this initiative is likely to degenerate into another inefficient
handout program. Of course, we'll have to get used to the newest euphemism for federal subsidy — "high priority government investment."

Nevertheless, history tells us that, early in a new presidential administration, it is likely that one or more hostile nations may try to test the resolve of the newly inaugurated chief executive. Several regional powers may attempt to reassess their ability to throw their military weight around — countries such as Iran or Iraq. Such "scares," at least in the past, have exerted a sudden and often unanticipated upward push on the military budget.

The image of the heavily armed republics of the former Soviet Union conjures up other potential threats of military action. So do terrorist groups which are active on every continent.

**Foreign Trade Policy**

The U.S. trade deficit (as well as our current account deficit, which includes services as well as goods) is down sharply. That hasn't dampened the enthusiasm of protectionists for restricting imports. While President Clinton's overall position on international trade tends to lean against protectionism, the balance of the new Congress is likely to be in the opposite direction.

Thus, we can expect more regulation of imports and foreign investment than under President Bush. But, as in every recent presidential administration, the formulation of trade policy will be a continual tug-of-war between the White House representing broader national interests (this means more open markets) and the Congress representing narrower interests that often advocate protection against foreign competition.

Sooner or later, the North American Free Trade Agreement (NAFTA) will be approved by the Congress — perhaps after some modifications in the form of legislation on labor and environmental matters. The necessary shove for a reluctant Congress will come in the form of the growing realization that Mexico is becoming a key customer for American products. Mexico is displacing Japan as our second-best customer. Canada, of course, remains the largest market for U.S. exports.
This tendency to trade mainly with your close neighbors is not unique to North America. Since the formation of the European Community, the Western European nations have shifted their trading patterns to favor EC nations — over 60 percent of the foreign trade of the twelve EC nations stays inside the EC. Although there is no formal counterpart in the Asian rim, the same tendency — and the same 60 percent — is visible in the patterns of commerce in that part of the world. Seen in this global light, NAFTA is a natural response to the increasing regionalization of the world economy.

The Economy in the Years Ahead

We can note several basic developments in the Clinton Administration which are close to certainty:

1. A far more activist federal government.
2. Much more government regulation.
3. Substantially higher business and upper bracket taxation.
4. Many more government spending programs, especially in financing and acquiring goods and physical assets.
5. On balance, however, far less change than promised in Mr. Clinton's economic plan, *Putting People First*. The difficulty in getting a host of programs enacted in a short period of time will force some priorities to be set. Even if the budget restraint were not a pressure, there are practical limits to how many new activities the federal government can undertake in a given period of time.

Another apparent shift in the Clinton Administration is the rediscovery of fiscal policy as a key lever to influence the performance of the American economy. The Federal Reserve's monetary policy is taking a back seat, at least for a while. In contrast to all the talk about job-creating spending activities, the formal Clinton economic program so far has been devoid of any attention to monetary policy. Despite the new label (infrastructure), old-fashioned pump priming fiscal policy is coming back in style.

After the many declines in interest rates during 1992, it is unlikely that the new White House will get much additional monetary ease to stimulate the economy. Of course, down the
road, if and when financial markets begin to react adversely to the new fiscal stimulus, Alan Greenspan and his colleagues will return to the limelight. Their various terms of office have years to go so that they will continue to be important players on the Washington scene.

In any event — and despite some assurances to the contrary — the focus of the national debate on economic policy will shift back from private initiative to government responding to the various problems that attract public attention from time to time. The prospects of a larger public sector will stimulate the economy — provided that financial markets do not blow the whistle on President Clinton's ambitious plans.

In that regard, we can recall the experience of M. Mitterand, when he took office in Paris over a decade ago. His proposals frightened world markets. The franc plummeted and financial capital began an exodus from France. The resulting negative feedback forced Mr. Mitterand to slow down or abandon many of his plans to nationalize industry and to expand public-sector activities. We saw some preliminary signs of this phenomenon here at home during the late stages of the [1992] election campaign. Long-term interest rates bounced upward in October when new polls confirmed the likelihood of a Clinton victory.

It seems that, for the next four years, we can expect more economic decision making to be made in Washington and probably the adoption of a national industrial and planning policy — with a new label yet to be devised. But perhaps the most important changes will be made in response to developments that are not now visible in anybody's crystal ball. Of course, that helps create full employment for economists. And that ain't bad.