

**"The President's Economic Program: The Summer of 1981
vs.
The Dangerous Decade of The Eighties"**

Economic Club of New York — June 25, 1981*
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When they told me I would appear tonight with a young prodigy of government affairs from Washington, an intense workaholic, married only to his cause, impatient with compromise, but the master of every bureaucratic detail and a great favorite of the press, I wasn't worried. How hard could it be, trading quips with Ralph Nader?

That tells you something about how long it has been since I worked in Washington.

But to be paired with David Stockman in front of the Economic Club, that is something else. I feel like Alexander Haig at a convention of English teachers.

I recently updated a report on "The U.S. in a Changing World Economy," first published in 1971 while I was still in the White House. This updated work—and a melancholy one it is—has generated a speech and over 100 charts now published by The Center for International Business. Its present title is "The U.S. Competitive Position in the 1980's—And Some Things We Might Do About It." The good news is that I'm not going to show you the charts. The bad news is what the charts show. They illuminate a fundamental imperative: *the U.S. must invest a large share of its current GNP (I say 3–4% more per year) in our economic future—in plant and equipment and in technology.* We are unfortunately living in an era of compound crises. Over the next decade, we will have to face maximum danger from the Soviet Union, maximum danger from insecure supplies of vital energy, and maximum danger from an absence of an underlying productivity thrust in our economy. My comments this evening will reflect this general framework.

I. The Reagan Program As Seen From Wall Street

One of my tasks tonight is to express the Wall Street view. As you have perhaps read, Wall Street has been told once again, at the highest levels, that it does not offer good economic advice. Yet, because the Street is not a message, but only a medium, the concept of Wall Street advice (like the concept of a Wall Street spokesman) is a kind of contradiction. The Street speaks only on tape—in prices and spreads—and these signals come from all over the world. Blaming us for the implicit message is like the familiar fat man blaming his obesity on the waiter.

* This statement was originally prepared for a joint appearance with David Stockman, Director of the Office of Management and Budget. Because of the House of Representatives vote that evening on the budget resolution, Malcolm Baldrige, Secretary of Commerce, appeared in Mr. Stockman's place.

Some Recent Changes for the Good

Since I voiced these worries, however, the Reagan Program has changed its complexion noticeably, and from my standpoint, it is all to the good. On the expenditure side, I was especially heartened by the President's open, if a little inelegant, confrontation with social security entitlements—a long-term fundamental if there ever were one. I hope history is generous and forgets the details of the ill-fated reform that was proposed. I suspect that it won't forget the watershed occasion on which a President declared, "This is an issue whose time has come." In the meantime, I say still another Bravo for his continuing devotion to the grinding task of meeting his 1982 budget goals. History will not forget that either.

On the tax side, the first year cut is smaller and effective later, which is fine. Furthermore, we are now hearing more about savings and investment and I will applaud cuts that promote both from whichever side of the aisle they may originate. Elimination of the "unearned income tax" is perhaps the most unambiguously beneficial reform imaginable. The current proposals to liberalize IRA's, cut the inheritance tax, and allow credits for R&D—while still problematic in their present form—represent an effort to confront some basics: retirement savings, family savings, and R&D investment.

The Four Schools of Wall Street

Now, what about Wall Street? Let me report what I have been hearing in the confessional. To the extent that the financial markets have been critical, I have found that their attitudes coalesce around four schools of thought.

First, there is *the school of analysts and econometricians*. These are brainy, quantitative personalities whose idea of fun is to put programs into models and models into computers. Needless to say, when the Reagan Program appeared it was a chance for new fun and hundreds of computers instantly went into high gear. And what was the output? Nine times out of ten, I am told, the numbers announced without inflection: "Does not Compute."

Let us recall the administration's projected scenario:

. . . Inflation on the CPI is scheduled to fall to 8.3% next year, to 5.5% by 1984 and to 4.2% by 1986.

. . . Real GNP will at the same time grow by 5% in 1983 and will average 4.4% from 1982 to 1986—almost 1.5% higher than the trend of the last decade. Unemployment will decline smoothly from 7.5% today to under 6% in 1986.

. . . Interest rates on 90-day Treasury bills will be 11% this year, 8.9% next year and below 6% at mid-decade. The real interest rate (adjusted for inflation) will be zero this year, 0.6% next year, and well below 2% for the duration. At the same time that interest rates are declining sharply, the program called for a 50% reduction in monetary growth.

. . . The savings rate—which averaged 5–6% in the 1970's—will rise to 8% in 1986 when business investment will equal 15% of GNP, reflecting the biggest investment boom in modern U.S. history.

The problem here, explain the econometricians, is that too many things seem to be moving in the wrong direction. Each of the program goals alone—a high real growth rate, a rapidly declining inflation rate, and a drop in the employment rate—is possible. We have accomplished each before. We have never in history, accomplished rapid economic expansion *together* with rapidly declining inflation.

What about the effects of tax cuts? Asked whether their models allow for a "Keynesian" or a "supply-side" reaction to the tax rate cuts, many analysts respond that it really doesn't make much difference. By 1984, given social security tax increases and bracket-creep, even assuming a low rate of inflation, *real* marginal tax rates on earned income will be only negligibly lower than now.

The real clincher, they add, is that the Program assumes a high rate of money turnover which, to their computers, is absolutely unthinkable given the low projected interest rates. Their two most likely solutions to this conundrum are either less growth or a Fed decision to renege on its monetary growth targets (because of political pressure from key interest-sensitive industries such as housing and autos).

Obviously, the econometricians base their coefficients on empirical and historical experience. Experience is, in a way, an unavoidable enemy to the President's bold attempt to change all the coefficients by changing all the expectations. But who is to take the first leap off the precipice of experience? And with whose money?

The second group might best be called *the "deficits are everything" school*. It is, I suppose, understandable that many financial people get fixated on how public sector borrowing and credit intervention influence the private sector economy. Quarter after quarter, they watch the U.S. Treasury, regardless of the interest costs, swooping down on and flying off with huge chunks of the credit market.

Is that concern unreasonable? During the 1970's the federal government dissaved (relative to budget balance) an average of 2% of GNP per year through deficits. In recent years, the trend has been worsening. Of all funds raised in U.S. credit markets (including equity), the federal sector borrowed an average of 6% yearly from 1966 to 1970, 13% from 1971 to 1975, and 19% from 1976 to 1980. Adding all guaranteed and federally-sponsored borrowing—very little of which goes to business—these percentages rise to a staggering 14%, 25% and 29%, respectively. Adding state and local tax-exempt borrowing, the results are higher still. Out of what we save, say the deficit worriers, more and more is being siphoned off before reaching the ordinary enterprise. Should the Fed attempt to relieve (even if it is only *expected* to relieve) this situation through monetary largesse, the inflationary cure would be worse than the original disease. These deficit worriers, as you might imagine, project deficits much higher—probably on average \$20 billion higher—than the administration's \$45 billion for fiscal year 1982. Some of their projections reach \$100 billion!

They are, perhaps a curmudgeonly and over-skeptical crowd, frightened by an official deficit number which (during inflation) is a misleading measure of how much government is actually dissaving. Nonetheless, as long as our rate of capital formation lags behind our economy's needs, it is hard to deny that we would be much better off if that deficit number were zero. Thus these deficit worriers, like I, would like to see even more *long-term pressure* on the *expenditure side* of the federal budget.

This untasty brew does not need any more ingredients to make it indigestible. Still, none of these credit watchers is unaware of the ballooning demand for debt money by the corporate sector. On a year to date basis, newly filed debt issues have zoomed from \$11 billion to \$19 billion. They know there is a lot more demand waiting in the wings to see if an "interest window" opens. Alas, it is assumed that with this many watchers waiting to go through, any such windows will not stay open long.

Then we move on to *the "incomes-policy school"* who insist the public must be directly involved in wage negotiations. There is an equally vocal group in the academic world but they tend more to price intervention. Their logic is predicated on a simple question: What basis do we have for believing that we can disinflate the economy without special attention to wage-price rigidity, and hence to the no-or negative-growth scenario of a prolonged recession? Theirs is not deficit-pessimism, but rather inflation-pessimism.

Finally, there are the *defense-skeptics*. These we should call *the "guns-butter-and-jam" school*. Like so many other critiques of the Reagan Program, their argument is grounded in the belief that hope cannot triumph over experience. When we try to pursue both increased prosperity and increased defense preparedness at the same time, inflation will, so they argue, follow like an inseparable triplet. Was this not the lesson that LBJ's wars were supposed to teach us? An economy that is straining to pursue several goals at once is an economy marked by high exertion, high expectations, and the inevitable concomitant of a rising wage-price-demand spiral. That is not the only reason for dubiety. Some defense-pessimists argue not so much from historical experience as from the effect of specialized military demand on industrial bottlenecks. When the military wants unusual quantities of a limited but vital resource—say a rare element or a ball-bearing for which production cannot be easily expanded—the military gets what it wants no matter how high the price or disruption to the economy. These hot-points, some believe, can exert a unique inflationary effect. At least one celebrated economist has now initiated an input-output model to study these effects.

It is difficult to claim that the Reagan defense buildup is precipitous by historical standards. It is not. The phasing is relatively gradual and the final spending target per GNP is relatively low. No one yet knows, moreover, exactly how the new defense money will be spent. But one thing is certain. The defense agenda adds one more uncompromisable goal, one more element of rigidity and risk, to the entire program.

To all these various dissenters, the President might be tempted to borrow a Casey Stengelism. "They say you can't do it, but sometimes it doesn't always work." Like Casey Stengel, I suspect the President is talking a different language. Be that as it may, what is to be done now?

What Can We Do Now: Some Guidelines For The Summer Of '81

First, here are some things that I hope we do *not* do:

Let us *not* move off the macro focus on what is good for our collective long-term future, and onto the micro focus of what will benefit which special interest. Let us hold off on anything "special" at this point: special interests, special industries, special regions, special consumers, special taxpayers. We have another kind of a very "special" problem: keeping the whole commonwealth under our eyes. The Program's initial approach was very good in this regard; I hope it is sustained.

Most important, let us *not* try—those of us who speak out or advise as private citizens—to out-politic the political negotiators by getting wrapped up in negotiating tactics. We thereby lose our most valuable public assets: to define directions; to think seriously about the future. Public officials welcome these assets and I can tell you from sad experience, they rarely have time to seek them alone. Most important, we should help to build a political consensus around these new directions, to make it politically possible for the President to do what I believe he wants to do.

Finally, let's *not* avoid setting a tight deadline. Uncertainty and delay are not friends of the economy.

Here are a few thoughts on the Summer of '81 Agenda—hopefully all within these guidelines.

II. Proposals For The Summer Of 1981

A Multi-Year Expenditures Budget To Go With The Multi-Year Tax-Cut

The President understands that economic recovery requires that the government provide an anchor of certainty in a world buffeted by surprise and jinxed with bad luck. Thus he has proposed a multi-year tax cut

and has supported multi-year monetary targets. *But multi-year certainty is also essential on the expenditure side of the federal sector. Such certainty is not only the desire of Wall Street; it is also, I think, the desire of most voters.* Indeed, if I could define one theme that unites the President, the people, and Wall Street—and that is a tall order—it is the conviction that government spending must be cut both significantly as a percentage of GNP and *steadily over the decade.*

The problem is that Americans now suspect that the adjective “budgeted” adds little or no meaning to the phrase “federal expenditures.” Consider fiscal year 1980. President Carter’s “lean and austere” blueprint originally allowed for a \$29 billion deficit. By the second Congressional resolution, the deficit had grown to \$36.5 billion. By October 31st, we learned that the official deficit had hit \$59.6 billion—or \$73.8 billion including off-budget outlays. Of course 1980 met with uncommonly bad economic luck, yet in 1981 luck is running in our favor on energy and food and we are doing even worse. Twelve months ago Congress promised us that this year’s budget would be fully in balance. Did anybody listen? The most recent announcement of the Senate Budget Committee indicates that our current budget, instead, will be more deeply in the red than last year’s. It will show at least the second largest deficit in our history.

We cannot blame these budget disasters simply on the intentional incontinence of a bygone Congress or a bygone administration. In fact, in the last few years we have seen the inauguration of remarkably few new spending programs. What we have witnessed in the late seventies is a growing and systemic inability to control the momentum of spending programs already mandated.

Bad Habits in Budgeting

I would call attention first to the recent habit of “off-budget” spending, a method by which many agencies remove loan expenditures from under their authorization limits. Off-budget spending accounted for nearly one-quarter of last year’s deficits. Even more important, on-budget outlays are growing increasingly “uncontrollable”—to use a formal term which obliterates the ordinary meaning of the word “budget.” Today, over 75% of the federal budget is considered “relatively uncontrollable under current law.” Of this 75%, only 25% consists of common-sense items such as prior contracts and interest on the federal debt. The rest—fully half of the budget—is uncontrollable because laws have explicitly linked it to events beyond the foresight, let alone discretion, of any mortal. It ebbs and flows with the Consumer Price Index, with national and regional unemployment rates, with quarterly economic growth, with the decisions of countless welfare agencies and disability boards, and with changing demographics, retirement ages, and life-expectancy trends.

Through the budget reconciliation process, of course, the President and Congress are trying hard to achieve overall spending level ceilings. But this process, renewed yearly and dependent on estimated projections, may not be sufficient. The magnitude of budget uncertainty still overwhelms the magnitude of budget restraint. Today, each 1% rise in unemployment automatically increases the deficit by more than \$25 billion. Each 1% rise in average interest rates automatically boosts interest spending, already \$80 billion, by \$2–3 billion. Each 1% rise in inflation automatically lifts spending on indexed entitlements by about \$2.5 billion. We used to think of these responses as “automatic stabilizers.” Recent history, here and in the U.K., has shown many of them to be automatic *destabilizers*—engines of further inflation and of capital stringency.

If budget spending surges automatically every time the economy hits one of these inflationary bumps, the difficult job of disinflation will get even harder. Resources will be drained on a massive scale from the private sector just when it needs them most desperately, and exploding deficits will unnecessarily aggravate the credit stringency which is already implied by the Fed’s tight control of monetary growth.

In this spirit, recognizing Wall Street's preoccupation with ballooning deficits, I proposed to some members of the Congress and to the Administration that it might be well to link a multi-year tax cut to actual performance in achieving budget deficit goals—ending with the balanced budget in 1984. The answer given was that tax-cut *certainty* was an indispensable part of the President's program; understandably, then, this was not negotiable. Let me then suggest this evening another approach: If tax-cut certainty is important, surely we could accept that controlling spending (and reducing deficits) is just as important.

A Multi-Year Budget Resolution

I assume that the leadership in the Executive and Legislative Branch is now committed to the basic concept of *sustained, significant* reductions in the growth of Federal spending. If not, I don't want to think about it. If they are, *then if the Congress passes a multi-year tax cut, should it not also pass a multi-year budget resolution and do it in a serious way?* (Should it not also pass a separate resolution to the effect that all spending under appropriation except for emergency matters will cease after September 30th until the reconciliation and appropriation bills for the fiscal year then beginning have been completed?)

A commitment to multi-year spending limits would not stand as an absolute guarantee against backsliding. Future Congresses cannot be bound absolutely. But multi-year limits, embedded in statutes and resolutions, would at least make future Congresses acknowledge by legislative action that they were breaching fiscal discipline. The choices would be far more visible, and opting for red ink would be that much harder.

Of course, some budget items, such as interest on the debt and unemployment insurance, are not amenable to multi-year caps. But I believe the strategy has far broader application than those in Washington have so far suggested. Unless it is attempted, fiscal restraint will remain hostage to economic and political uncertainty, and budget balance will occur only in econometric projections, never in reality. I agree that the tax cuts in themselves put some continued pressure to reduce spending because of the fear of deficits. Yet I also believe that the fickle Congressional environment benefits more from explicit and continuing pressure. Even Ronald Reagan and David Stockman could use some sustained help in 1982, 1983 and 1984. Politics, after all, are politics and Congress, after all, is Congress.

Of one thing I am sure: *If Wall Street were confident that this year's budget attitudes would prevail next summer, and the next, the dissenters would come out of their closets and cheer as they went long on bonds.*

Summer of 1981 Tax Changes and Investment Incentives

I sense a happy trend today toward more tax cuts designed to encourage savings and investment and, for the first time in recent years, to encourage research and development. To the extent feasible, I'd recommend jumping on that bandwagon.

1) Eliminating the additional tax on unearned income over earned income

To my mind there is no more pernicious and regrettable distinction in our tax code than this one. In effect it says that citizenry will be taxed more on savings than on labor, and thus levies a penalty on the deferral of consumption for investment purposes. The greatest beneficiary of the unearned "max tax" is undoubtedly the tax shelter industry. Its contribution to federal tax revenue is miniscule (see Chart C-1).

- 2) Increasing the long-term capital gains exclusion from 60% to 70%** (In combination with the reduction in the unearned income differential, this proposal would have the effect of lowering the maximum rate on long-term capital gains from 28% to 15%.)

As members of the securities industry, we take the privilege of pointing out that the last reduction in the maximum capital gains rate from 48% to 28%, which was signed into law in September of 1978, has been eminently successful. Last year, despite turbulent financial conditions, \$20.3 billion of new equity capital was raised, more than in any previous year and nearly twice the level of equity capital raised in 1978. More importantly, now that the capital gains tax rate increase of 1969 has been repealed, many small companies have regained access to risk capital. From 1975 through 1978 small companies raised, on average, less than \$100 million in equity per year; in 1980 alone they raised more than \$800 million (see Chart D-5).

And the revenue costs of the 1978 tax rate cut? The latest Treasury Department estimates show that—despite earlier Treasury estimates that capital gains tax revenues would fall by \$1.7 billion—revenues to the federal government in 1979 have *actually increased* by \$1.8 billion (the largest increase in the history of the capital gains tax!). The effect of rising equity prices and an increased turnover of capital overwhelmed the effect of lower tax rates (see Charts C-2,3). Congressman Steiger, who co-sponsored the 1978 tax rate cut, deserves to be honored posthumously. Would he not be looking now, wherever he may be, and smiling at the results of his handiwork: so many obvious benefits and so few discernable costs—including a political backlash that never happened.

Yet even at lower rates, our law still leads to tax anomalies shared by none of our toughest international competitors, such as Japan or West Germany. First, due to inflation, our law often levies a tax on long-term, real financial losses. The last time someone checked, \$4.5 billion of taxes were collected on capital transactions which in real terms represented a net loss of \$1 billion. Perhaps we should call it a “capital loss” tax. Second, I leave you with the somber thought that the only way to avoid our individual capital gains tax is to die.

We must keep on the path toward a further reduction in the capital gains tax rate. In the years ahead we will have to raise and reallocate massive sums of equity capital for the renewal of basic industry badly in need of modernization, for further development of alternate energy sources, and most importantly, to fund the growth of our younger, more dynamic industries where most of the new jobs are created.

3) Enacting new incentives for research and development

One of the critical yet most ignored areas of investment we need to stimulate is research and development. Our total national spending of R&D has remained essentially stagnant for more than a decade (see Chart D-1) and the trends vis-a-vis our major trading competitors are drastically different (see Chart D-2). This decade of stagnant investment in our technological future can only be compared to the explosive growth in our regulatory burden. *As a result, the total compliance costs of regulation are now about four times the private sector's own investment in R&D.* Put more hopefully, only a 25% reduction in this regulatory burden would release sufficient resources to double the private sector's investment in R&D. It would be hard for me to conceive of a more productive trade-off.

We are, moreover, the only country to spend a substantial portion of our national R&D budget on military and space. Thus we enjoy the enigma of being a nation that can put men on the moon but has difficulty competing in such mundane commercial products as automobiles and consumer electronics. Since our increased military spending is going to draw further technological resources away from the private sector, it is up to us to find ways of increasing our overall level of research and development. Many of our trading partners have specific R&D incentives that go far beyond our current write-off provisions. An effort to create similar incentives for our private industry would certainly include: a) *Allowing fast, flexible write-offs for R&D capital investments;* b) *Eliminating the unfavorable tax treatment of externally-acquired patents and technology;* c) *Allowing domestic R&D expenses to be deducted entirely from U.S.—source income;* d) *Enacting special incentives for small, technologically-based companies, (i) More liberal loss carry-forward*

provisions for these small companies, and (ii) *More flexible stock options for managements of small venture companies.**

III. Looking Beyond The Summer Of 1981: The Politics Of Investment

A Frenchman once said that "if economics gets important enough, it becomes political." The decades of the sixties and seventies have also demonstrated that the inverse is true: when politics get important enough, it becomes economics.

A special interest, constituency politics of the last fifteen years has resulted in an extraordinary regulatory burden, a budget out of control, expenditures rising from a revolution in entitlements, and an economy in disarray. As the social consensus dissolved, so did our collective ability to maintain basic discipline over the instruments of fiscal and monetary policy. If we do not reverse these trends, the decade of the eighties will be one of the most dangerous in our history.

I do not think we can rebuild the foundations of a new prosperity unless we simultaneously rebuild the foundations of social stability. A conservatism of nostalgia can provide little guidance for the new decade. This Year of the Budget has allowed us to get rid of the excess baggage of the 1970's. We will now be able to travel lighter—but we must decide where we are going.

We know the future will confront us with huge and growing claims on our base of productive assets. Our national security needs are mounting rapidly. Converting to new energy sources will require massive resources. And the aging of our population—the growing ratio of retired people to working people—will put ever-increasing burdens on our productive capacities.

Thus, our premier economic problem (along with inflation) is investment. The task for the new decade is to dedicate a much larger share of our resources to the future, not to current consumption. Earlier, I estimated our needs for added investment in the economy at 3-4% of GNP, upwards of \$100 billion annually, but this is not a matter where precision is possible or necessary. That a huge shift of resources to the future is required seems to me beyond debate. We must dramatically move away from a lotus-eating emphasis on public and private consumption to a *much* greater degree than is being envisioned in the budget and tax bills of 1981.

Policy Differences or Political Realities?

Much—too much—can and has been said about "hard policy" differences or dissents with the President's program. Imagine that the President were here tonight and the Press were not. Would he disagree that major increases in savings and investment are central to reviving the economy's long-term prospects? Would he not accept that we still need to move several percent of GNP—a huge amount—from public and private consumption and into investment for our economic future? Would he disagree that further budget cuts, at the expense of entitlement programs, would help this process enormously? Would he disagree that a substantially greater tilt to the tax system, in favor of savings and against consumption, is needed? I expect he would share all these views, sincerely and enthusiastically.

Why then are these features not more prominent in the Reagan fiscal program? The answer, I believe, is simple. These were considered impolitic: the President probably felt that his program was at the outer edge of political feasibility.

He may be right. If he is, there is an indispensable job for us to do. We must construct a safety net for the politicians, so they can dismantle some of the politically-inspired safety nets they have felt forced to construct. The business community should set to work constructing a new coalition which will permit the

* See Appendix, page 25 for more complete statements on these suggested R&D incentives.

President to convert the Year of the Budget into a decade of fiscal reform. You and I must take the lead in building a new coalition for investment, much as Reg Jones led a brigade of business leaders that helped transform capital formation and accelerated depreciation from a political no-no only a few years ago to a political yes-yes today.

A Safety Net . . . For the Needy or For the Politicians?

The first, brute question is *whose* resources—whose current income and wealth—is to be dedicated to building up the nation's future productive capacity. One cannot soak the poor and I would fervently hope we would not want to. As for soaking the rich, one has yet found a device for this purpose that did not also create massive incentives against private savings and investment. That leaves the broad middle class. Political leaders of all persuasion have bent over backward to evade this conclusion. The proposed budget casts a big safety net over a peculiar set of federal programs—Social Security, Medicare, veterans programs, federal employee pensions, military pensions. This has been billed as a safety net for the needy. But it is of course a safety net for politicians. The only common denominator in these programs is that their benefits dispense on criteria other than need.

The other common denominator is that this political vending machine mentality of the 1960's and 1970's was *bi-partisan*. Consider our local scene. Implicit deals and long-term bargains between special interests and politicians, starting out small, finally resulted in near bankruptcy for our great city. Was this a one-party proposition?

Creating a coalition for investments means convincing the broad majority of voters that they have, in the long run, more to gain from a general improvement in economic conditions than from whatever special bargains they have struck in the political marketplace. We must make citizens think again as citizens, rather than as special pleaders.

Investment is a bet on the future. Americans will not make this bet—not, at least, often and forcefully enough—unless they can envision a *common* future. We are today less a community than we were, and more a collection of self-interested individuals and groups. Unless we regain our sense of the platoon, it is difficult to believe that businesses and consumers alike will see it in their rational self-interest to place huge financial wagers on the future health of our economy.

So the second great challenge posed by the politics of investment is to secure a plausible common future for all Americans. And, in *this* endeavor, I don't think it is out-of-bounds to talk about "soaking the rich." There is no realistic prospect of engaging the middle class in a massive commitment to greater investment, or of securing the understanding and support of the poor to this long-range effort, unless those at the top of this economy share the burden in a way appropriate to them. Will the nation's well-to-do commit themselves to upgrading the country's military security in ways that go beyond throwing money at the problem? Will calls for wage restraint be matched in our corporations by a commitment to tie executive compensation to the long-run success of the enterprise?

What is the agenda for this new coalition? In every case, the task is to take resources from public and private consumption and dedicate them to savings, to the nation's future prosperity. Unfortunately there are no easy places to find these resources. This makes for a list of the least politically-appealing issues you can imagine. Every issue is either a political no-no or what we Nixon-veterans used to call a political MEGO (for "mine eyes glaze-over").

To demonstrate that I should never run for political office, let me enumerate some of the political untouchables of the eighties that must nonetheless be confronted.

INVESTMENT AGENDA FOR THE EIGHTIES:

1. A Counter-Revolution in Entitlements

While a multi-year, shock-proof budget is a necessary pre-condition for economic planning by private markets and businesses, the essential political question remains: which part of the budget is in direst need of control? My first observation here is that we must focus primarily on controlling nondefense-related outlays. However much we might hope to economize on defense spending (and I will say something about this later), most Americans see no alternative to the phased defense increases. One thing is certain: it has not been defense spending that has caused our current budgetary mess. In 1980, defense constituted about 20% of all federal spending, the lowest percentage since 1939. Defense spending as a percentage of GNP, in fact, has declined rather steadily for decades, from 13-14% during the Korean War to less than 5% in 1980. Nondefense spending, on the other hand, has been climbing swiftly, from about 10% of GNP, in the middle 1960's to 18% of GNP in 1980. (Clearly much more than my investment "bogey" for the eighties of an additional 3%-4% of GNP.)

My second observation is that the single, overwhelming force behind this nondefense expansion has been the growth of entitlement transfer programs. The numbers again leave no room for doubt. Over the last 15 years, federal payments to individuals have grown at an annual rate of 15.4%, or 8.2% in constant dollars. Not only has this rate vastly exceeded anything else in our economy (consider how many companies you know with this kind of growth record), but it is precisely *double* the annual rate of increase for nondefense spending as a whole. In 1955 federal payments to individuals totaled 3.7% of GNP; today they total 10.5% of GNP and constitute nearly half of the federal budget. Nor is it just a question of past growth. Almost all of these entitlements are indexed (I would say *over-indexed*) to the price level, and they are ever-prone to expanding eligibility and real benefit increases.

Social Security outlays more than tripled in the 1970's, with average benefits expanding 30% in real terms, versus a *decline* of nearly 10% in real after-tax wages over the period. Pension outlays for federal civilian employees rose more than four-fold, with unfunded pension liabilities expected to total \$840 billion by 1986 according to the Congressional Budget Office. Speaking of Federal pension plans, I have asked each of the companies on whose boards I serve whether they have 100% fully indexed pension plans for their employees. *Not a single company* has such a program. Their indexing is typically ad-hoc or partial at best. Do you know of any 100% indexed corporate pension plans? With 100% indexed government pensions and very early retirement, we now see federal and legislative retirees earning as much or more than their full-time counterparts. In fact, a Congressman retired (at full pension) by the voters at the close of the Ford Administration could now be making *more* than those of his colleagues who are still active on the Hill. Adding full indexing to the already generous pension levels, it is small wonder that average pension benefits from all Federal plans is about two-and-one-half times the average benefit from private plans!

Thus, my third (and I trust controversial) observation is that the current administration, by exempting up to now the lion's share of these entitlements from restraint, is losing its most direct opportunity to regain budgetary control. These "safety net" transfers — primarily Social Security, Medicare, and veterans benefits — comprise fully 37% of this year's budget. Because the sums here are so vast, even minor indexing revisions could generate enormous savings. The Congressional Budget Office has estimated, by way of illustration, that simply holding Social Security benefit increases to 85% rather than 100% of the Consumer Price Index could save \$43.9 billion over five years.

The rhetorical defense against touching entitlements is that they go to the poor. In fact, they do not. If they did, we would be entirely eliminating poverty many times over. Chart data that I attach indicate that from all public transfer programs in this country — mostly funded of course at the federal level — 62% of all

transfers do *not* go to the poorest 20% of all families. Strangely, some of the smaller means-tested programs which this administration has been willing to trim, Medicaid and Foodstamps for example, target the poor relatively well. But if we look at the largest so-called social insurance programs (such as Social Security, veterans benefits, and federal pensions and disability), we find that 67% does *not* go to the poorest 20% of all families. For example, of all households receiving social security, only 24% are in poverty. Of all households receiving medicare, only 18% are in poverty.

We must face the fact that the "safety-net" beneficiaries represent the middle-class far more directly than they represent the poor. To repeat, they are a "safety-net" for politicians who, as yet, do not dare ask from the middle-class such an explicit contribution for budgetary control and economic revival.

INVESTMENT AGENDA FOR THE EIGHTIES:

2. The Politics of Aging

The explosion of entitlement spending in the 1970's owes much to the rise of "grey power." Again, over the decade, Social Security outlays more than tripled; federal employee pension outlays quadrupled; Medicare outlays quintupled.

And the full force of the "politics of aging" is yet to be felt:

... In the early part of this century, only 4% of our population was over the age of 65. By 1960, this had doubled to 8%. This year, it has grown to 11%. By the early part of next century, the aged will account for 15-20% of the population. And in fifty years the demographic experts are predicting over 20%, or over five times the size of the elderly ratio that we had at the beginning of this century.

... In the next fifty years, the population of those over age 65, the recipients of our programs for the elderly, is expected to grow twenty times faster than the 18 to 65 age group, the tax-paying contributors.

... Furthermore, our older people are getting older, which is another way of saying that they will be recipients longer. At the turn of the century, 29% of the elderly population was over age 75; by the end of this century, that share is expected to rise to 43%.

... Under current formulas, the payroll tax rate for Social Security would have to rise from today's 13% to 20% or more by the year 2000 just to keep the trust funds in current balance. In fifty years, with no changes in the Social Security system, the payroll tax rate would have to double, or even triple.

Thus, federal spending for the elderly, which tripled in the 1970's, is apparently poised for another explosion in the new decade. Under the Reagan budgets, this spending for the aged climbs from \$143.5 billion in 1980 (nearly \$6,000 per person aged 65 or over) to \$168.5 billion this year and to \$190.6 billion next year, a two year increase of more than \$45 billion, or more than 30%. The share of the Budget consumed by these programs would rise from 24.9% in 1980 to 27.4% in 1982. By 1960, in comparison, the aged's share of the budget was only 13%.

The elderly are not only becoming more numerous. They are also growing more powerful politically. They form one of the most vociferous and well-organized lobbies on the Hill. Making up 17% of the electorate, old folks go to the polls at a 65-70% rate, versus less than 50% for the population generally.

Don't get me wrong. With every passing year, my identification with this interest group grows more personal. But we are reaching the limits of common sense and equity. Is it fair, or even plausible, to ask the

next generation of young workers to face a 50% or more increase in the Social Security payroll tax? It is ironic that our young people, who might find it difficult enough to pay for the retirement security of their own parents, are without knowing it paying for everybody else's parents. How long before these young people learn that what they thought was an annuity is rather a spending program to meet *trillions* of dollars (literally trillions!) of claims? Bankruptcies are *always* hard to face.

More of the Same is Too Much

What is to be done—both politically and morally? What is to be said to the aged? In the first place, we must remember how much has changed since the era when most of these programs were first conceived. One of the original arguments for Social Security was that it would be a job-distribution program, alleviating unemployment by getting older people out of the work force. Today we need to welcome more workers. Americans over age 65 will increase by 28% in the 80's, while new entrants to the labor force (age 18 to 24) will decrease by 16%.

Second, reform is in the elderly's interest as part of a fair burden-sharing deal to get inflation under control.

Third, in every area except benefits we have redefined what we mean by aged. Well we should, since they are healthier, live longer, and again, we need their output. If the required retirement age has moved to 70 years, why should this trend not be recognized in legislated entitlements? To be sure, early warning is needed, and this is fully consistent with the Reagan principle of predictability of government. To be equally sure, we need to devise reasonable incentives to make it economically worthwhile for our aged to work. Thus, we need the aged to earn a larger share of the GNP — indeed to enlarge the GNP for their good as well as our common good.

Fourth, the American people must come to understand that the new politics of investment are simply incompatible with the old politics of aging. Certainly the economics are incompatible. We cannot ask the working population to provide their country with massive new savings while, at the same time we ask them to pay for uncontrolled increases in federal benefits to the elderly. These increases deter saving both by reducing *current* disposable income and also by increasing the promises of *future* unsaved benefits.

Instead, we need to defend retirement security with a new kind of "triad." Leg one of the triad must include Social Security benefits, but at generally reduced levels (ensuring only that a basic "floor" or minimum remain untouched). Leg two would consist of private and institutional pensions, enlarged as much as possible through legal and tax-code incentives. Leg three would consist of private savings, similarly enlarged. If we succeed in building such a triad, we will have transformed a retirement and spending disaster into a savings and investment triumph.

My University of Chicago professors used to tell me that if you have no alternative you have no problem. In that special sense, we have no problem and we have no alternative but to do something soon. Thus, I can safely predict that any list of the hottest issues of the 80's must include Social Security retirement ages, indexing, and taxing.

Now permit me to go further down this unpalatable menu. It may soon provide nourishment for public debate, even if it is still poison for politicians.

INVESTMENT AGENDA FOR THE EIGHTIES:

3. The Politics of Housing

Ensuring that considerably more of our resources be directed toward savings and investment begs an important question: What sort of investment are we looking for? At the risk of being pilloried for assaulting

yet one more prerogative of the American middle and upper classes, I will advance the proposition that more than any country, we are deliberately tilting, or perhaps pushing, our already scarce savings toward residential investment. Super-abundant housing, of course, is an American dream, but it is a dream that we must weigh carefully against the encroaching nightmare of zero economic growth.

Business Investment Down, Housing Investment Up

Consider the anomaly. On the one hand, the growth rate of our ratio of business capital to labor has for two decades remained far lower than any of our foreign competitors. During the last five years, for the first time since the Great Depression, it has been utterly stagnant. In an increasing number of key, capital-intensive industries, foreign plant and equipment is becoming visibly newer and more modern than our own. Our plants average 16 to 18 years in age whereas Japan's average 8 to 10 years.

On the other hand, over the same period, we have far outspent any other nation in home building and home improvement. By any index of quantity or quality, we are the best-housed nation on earth. *When we compare the 1970s to the 1960s and measure the large decline in the growth rate of our stock of fixed capital, it is worth noting that the entire reduction came at the expense of business investment.*

Perhaps Americans just have a unique love affair with houses. A more plausible explanation, I think, is that over the years we have granted tax and subsidy incentives for residential investment which we would never dream of giving to business and which are unparalleled in most foreign economies. We have made housing an investment where the implicit rent of owner-occupancy is not considered taxable income, where property taxes in fact can be deducted from income, where capital gains (through roll-over and the \$100,000 exemption at age 65) are rarely taxed, and where builders receive special write-off provisions. Mortgage institutions are allowed still further tax-breaks designed for their benefit only. Finally, after establishing an alphabet soup of federal and federally sponsored agencies to ensure home-owners 80% to 95% debt leverage, we allow the deductibility of all nominal interest expenses. Adding together only the values of those incentives which we can measure, we reach an estimate of over \$20 billion in housing tax expenditures for fiscal year 1980. Then we have to add on the direct federal subsidies to low and middle-income home-owners during 1980. These amounted to over \$8 billion, not including any rent subsidies. No one really knows what future costs we will incur for about \$350 billion in federally-insured and guaranteed loans for homes already outstanding. Just the relative levels tell us something. \$350 billion for homes might be compared to perhaps less than one-tenth of that figure in insured and guaranteed loans outstanding for industry.

These substantial benefits have become even more desirable with the onset of double-digit inflation and the steepening marginal income tax rates faced by most home-owners. Housing is more than just an inflation hedge; nowadays it is a real inflation winner. It is sometimes said that the rapid climb of housing prices over the last decade indicates that housing is becoming less affordable and more scarce. Look again. After adjusting prices for quality, the declining real value of mortgage debt over time, and *negative* real after-tax interest rates, most owners feel that they could hardly afford *not* to make the purchase. Despite the fact that the number of persons per household declined sharply during the seventies, the formation of new households is still being outpaced by the construction of new homes. Investment in single-family home building, as a share of GNP, is still rising. And with a growth in the eighties in the prime house-buying market, ages 25-34, we should expect this to continue, unless some long-term decisions — not simply economic but political decisions — are made soon.

Can the U.S. — with perhaps the lowest net investment rate in the industrialized world (about 6% of GNP) — afford to commit about half of that (about 3% of GNP) indefinitely to residential investment? Our toughest international competitors, saving far more than we, would still be astonished at the idea, for instance, of full interest deductibility on home mortgages. They certainly don't discourage home-ownership; their idea is simply that if you want to own a house you should have to *save* somewhere along the line to

really *own* it. Japan, for instance, is not famous, to say the least, for its fine housing. But the way its economy is growing, all Japanese will soon be able to afford good housing without overwhelming special incentives. The U.K. is the only obvious instance of a nation which subsidizes housing perhaps as much as the U.S. It is the exception, I might add, which proves the rule.

Must we then put an end to such tax sweeteners as mortgage interest deductibility—a policy so beloved by home-owners and so resented by rental tenants? Even I would hesitate to campaign for such a politically hopeless reform, especially since future success in reducing inflation will accomplish much of this reform automatically. We must, however, rethink seriously the capital costs of some of the strong tax and financial biases which underlie our American housing dream. *More importantly, we might suggest that some of the incentives enjoyed by housing—such as critical exemption from capital gains taxation—are not eliminated but rather extended to include other productive assets which may not shelter our own family but do enrich our society.*

INVESTMENT AGENDA FOR THE EIGHTIES:

4. The Politics of Defense

The weakness of our economy aggravates, but is by no means the only cause of, our major social ills. We cannot mend the fabric of our society by money alone. While Americans understand this lesson with regard to our social problems, we show less comprehension of the realities and priorities of defense. We seem to assume that we can produce the necessary armed forces merely by spending more funds on weapons and equipment.

Before we add to our weapons stock, however, we must be certain first that we have a strategic plan telling us how, where, and for what purpose we will use our weapons and, second, that we have manpower competent and well trained to wield them. On the first point, I am a non-expert; on the second, common sense tells me that too little attention has been given to it.

President Nixon has acknowledged that he erred in permitting the draft to expire. The so-called "voluntary army" is in many ways a cop-out by the rich and middle classes. It reflects a refusal to face facts, a sense that we Americans can avoid any personal responsibility for defense so long as we provide sufficient money to hire enough people. At a time when effective defense depends not so much on our ability to procure sophisticated weapons as on the ability of well-trained forces to use them effectively, our armed services are forced to depend all too much on personnel whose low level of literacy and education largely precludes them from civilian employment. The result is what some call our current army of unemployables. This recalls Wellington's remark when shown the army he was to lead in the Peninsular Campaign, "I don't know what the enemy will make of them but, by Gad, Sir, they terrify me!" Both our adversaries and our allies are fully informed of the sad state of our military forces. (Have we not said that the perception of our strength is inseparable from its credibility?)

We must take more than a taxpayer's interest in building an effective defense force. All classes of society must become engaged, not merely the members of the lower-income groups who join the army in default of anything else to do. Middle and upper class fathers, such as myself with four sons, must shed themselves of the comfortable illusion that we can subcontract the defense of our country to others. It is not a "make or buy" decision.

Our first step should be to adopt legislation that would provide a limited period of compulsory military training for all Americans. Exemptions should be very limited. Under this plan, once the training term is

completed each individual would have the option either of signing up for the reserves or enlisting in the regular armed forces.

To sum up, though we Americans accept increased defense expenditures, we no longer feel deeply involved in the common task of providing for the security of our country. No country will be secure so long as its people think they can buy their armed forces as the Union did in the American Civil War. I recognize that this subject is politically unpalatable, but the sooner we reinstate some form of national service, the better. Nothing would do more to strengthen the belief of other nations in our seriousness of purpose. Likewise, nothing would make what we do spend on defense hardware more cost effective, leaving more resources available for investment in our economy.

INVESTMENT AGENDA FOR THE EIGHTIES:

5. The Politics of Energy

The energy issue has receded somewhere to the back of our minds—somewhere between ignorance and apathy. That reminds me of the philosophy professor who asked his class one day which was worse, ignorance or apathy? A sleepy student groaned, “I don’t know and I don’t care.”

Another world oil price shock would derail our hopes for achieving a disinflationary recovery by the mid-1980’s. Yet experts on Mideast politics tell me that we would need a miracle to get through the next decade without a minor supply disruption, and that we would be very lucky to get by, without a major one. The CBO has recently estimated that just a two million barrel per day cut-off in 1984 would cost us \$146 billion, or 3-1/2% of our current GNP. Such a blow would send even the most brilliantly successful economic plan into a tailspin. But are we acting rationally to prevent this from occurring?

As everyone knows, the oil market is now glutted and prices are falling in real terms. The Administration has wisely accelerated the dismantling of the perverse system of price controls and entitlements which distorted our energy economy throughout the 1970’s. But the energy crisis is not over. We have been through this before. By late 1974, the first OPEC embargo was fading from memory, a glut was developing, and real prices were beginning a multi-year decline. The nation fell asleep.

Least we repeat this folly, a few simple facts need emphasis. No responsible analyst expects any long-term increase in domestic oil production during the dangerous decade of the eighties; many expect a decrease. Our vital dependence on oil imports will persist well into the next century, and our allies’ dependence will grow yet stronger. From 1973 to 1980, the share of our imports coming from the Western Hemisphere fell from 40.5% to 13% and the share coming from Saudi Arabia and Libya rose from 22% to 35%. In all, according to CIA estimates, the share of our imports from politically insecure nations rose in the period from 39% to 56%. Unless one assumes that the Middle East, and in particular Saudi Arabia, Algeria and Libya, will see no great political turmoil over the next decade—quite an assumption!—our economy remains critically at risk.

Reducing the Unacceptable Risk

There are numerous ways to mitigate this risk, but none has really engaged our sustained political attention. We have waited so long and listened to so much empty rhetoric from both sides of the political aisle—remember “Project Independence” (by 1980, that is) and “the Moral Equivalent of War”—that our alternatives all seem Vietnamish. They are all choices between the least worst of grotesque alternatives.

How much, or rather how little, imported oil from unreliable sources are we willing to rely on and what is it worth to us to reduce these amounts to various levels? Reasonable men can disagree about these twin goals; reasonable men would not disagree that our current vulnerability is unacceptable.

The fact of the matter is that we are so far behind that we need *both* a good offense *and* a good defense. I trust the Economic Club membership would quickly agree on the necessary supply-side offense: more coal, nuclear, gas, and so on. So let us discuss here the side most of us in business would rather not talk about: the defensive side of energy policy.

A Good Energy Defense

The strategic petroleum reserve today contains only 162 million barrels of oil, about 3 to 4 weeks worth of oil imports. By the end of the decade it is scheduled to contain 750 million barrels, about four months' worth. Can we wait that long? Should we not use the current glut to fill and build the reserve as fast as possible? What additional steps—and if necessary wartime-like steps—should be taken to increase storage capacity?

Furthermore, if we were as efficient as our OECD partners, we would be oil exporters. We cannot—and certainly they do not—ignore the fact that with 5% of the population, we account for 30% of world oil consumption and a stunning 49% of world gasoline consumption.

What are we as business people going to do about this? Fred Hartley of Union Oil, Tom Clausen of the World Bank, Charles Brown of AT&T and I are undertaking a major effort to raise some money from the business community to further encourage a serious program of energy conservation. It will make us far more credible on supply alternatives if it is clear that we are equally persuaded that we should conserve more energy.

Let's address the basics: we tax oil production but do little to discourage oil consumption. Does this make sense for a nation that needs to switch its tax system generally against consumption, or that fails every year to balance either its budget or its balance of trade, and that is forced to import major amounts of oil from a region of the world that could bring us to our knees? As I review the alternatives on the energy conservation front, I am forced to the conclusion that there may be no practical alternative to a very large oil or gasoline tax in this country, perhaps phased in. It would do a great deal to reduce dependency on imported oil. Meanwhile, we could "recycle" this revenue and/or use it to build up our strategic storage and to finance the additional savings and investment incentives we desperately need.

At the present time, few politicians, dead or alive, would take on the issue of a significant oil or gasoline tax. As with these other currently untouchable issues, the task of the private citizen is to make it politically possible for our leaders in public life to do what is truly in the national interest. No concept of national security worthy of serious debate can ignore the central question of our unacceptable energy vulnerability.

INVESTMENT AGENDA FOR THE EIGHTIES:

6. The Politics of Pay

For the Reagan program to work, we will need a big break in wage inflation very soon. In practice, that will require a large decline in wage increases for the big unions coming to the bargaining table over the next year. To be more specific, the Reagan inflation scenario needs some help from his friends, the Teamsters, as well as his "adversaries", the UAW.

Wages make up two-thirds of production costs and dominate long-term inflation trends. The other components of the inflation indices—interest rates, commodity prices, even capital goods prices—move in relatively swift response to supply and demand. But labor compensation marched stubbornly forward for most of the 1970's in a narrow band between 8% and 10%, registering only faintly and with considerable delay the great waves of recession and the great CPI explosions that punctuated the decade.

Where is the solution? Today wage controls find as many friends in Washington as in this room. At least, I hope so.

Perhaps, as some tell me, the unions have now fixated on MIB and will experience a spontaneous expectation revelation as the Fed holds the line, but I doubt it. In wage negotiations, unions tend to look backward at history, not forward to projections. The solution must come, I think, through another kind of revelation: that wage restraint is necessary to the competitive survival of key American industries.

Paying the Costs of Oversized Waged Bargains

The great unions that have historically set the pace for wages throughout the economy, the UAW and the Steel Workers, all now operate in industries under severe competitive attack, and the competitive problems faced by these industries often trace directly to oversized wage bargains. In the mid-1960's, hourly labor costs in the major auto companies were only 20% above the average for manufacturing industries generally. Today, auto's labor costs exceed the manufacturing average by 60%.

These workers have been pricing their industries, and themselves, out of the world market. In Japan, autoworkers do earn more than the average manufacturing worker, but the gap is only 5%, only one-twelfth the differential in the United States. And need I say anything about worker productivity in the Japanese auto industry? The secret to slowing down wage inflation in these sectors is to impress on the unions and on management what is required for the long-term survival of their industries. Protectionism by any name does not convey that message.

First, the Government's chief role in this effort is to let the competitive marketplace do its job. Let's start with deregulation. Those who doubt that deregulation will diminish wage inflation should examine the airline industry. Deregulation has brought an explosion of entrepreneurship that has greatly reduced labor costs (about 65% lower than regular airline costs according to our airline analyst, Bob Joedicke) and workers and management in the regular airlines are beginning to respond. Wage freezes, productivity deals, and employee stock ownership plans sometimes all tie together. Thus, trucking deregulation in high gear is a must. Wall Street, of course, had its own heavy dose of deregulation in the mid-seventies. But we are a healthier and clearly a more competitive and efficient industry now. It even *feels* better (after it's over, that is!). Reforms are also needed in the Fair Labor Standards Act and the Davis-Bacon Act. Both serve to drive up labor costs and at the same time limit employment opportunities, especially to our young people.

Second, business management must re-examine the range of its methods for improving productivity and concentrate on areas, such as worker participation, that it has too often neglected. In the face of fierce and intelligent foreign competition, all employees must feel they have an active stake in the long-term viability of the company or the industry.

Third, *management must take steps to improve its own productivity*. As a starting point, it should accept more effective discipline on its compensation—the discipline of long-term performance. The other day, for instance, I heard an intriguing if sobering idea: that significant amounts of senior management bonuses be paid out over five years *after* retirement, in order that they better reflect the lasting effects of the manager's performance.

INVESTMENT AGENDA FOR THE EIGHTIES:

7. A Reverence for Saving

There is much talk these days about the national need for savings and investment, but I wonder if our people and our policymakers have yet grasped the full implications of our problem. It goes far beyond the

current politics of cutting the max-tax rate or the capital gains tax rate. It presents us with a challenge that we will face well into the next century. The negative task of releasing at least 3% of GNP from the public sector is, in my mind, a mere preliminary. The positive task of investing those resources in our future will require reversing our entire framework of public incentives. We must begin to discourage the habit of present consumption.

We must also recognize how vast our investment needs are. By allocating an additional 3% to business investment over the next decade, we would be asking business to invest \$6.2 trillion (assuming that nominal GNP grew at 10% per year and inflation were sharply curtailed). A sum of this magnitude would nearly triple the current asset base, net of depreciation, for the nonfinancial sector of the economy. In every previous ten-year cycle the net asset base has approximately doubled.

Furthermore, given the present state of corporate balance sheets, this investment must be primarily internally financed. Assuming (as we must) that inflation will recede in the 1980's, the conditions that now permit growing debt-equity ratios will cease to exist. For many industries, further debt financing will be a dead-end option. Clearly, our new need for *equity* will require a complete reversal of recent financial trends. In the decade of the 1970's newly-issued equity accounted for only 2.9% of all funds raised in the credit markets, versus 6.7% in the 1960's and 8.5% in the 1950's.

Thus, as we ponder tax proposals for the 1980's, our first priority must be to maintain a sizable spread between the effective tax-rate on savings as opposed to the tax rate on consumption (or even on earned income). Our second priority must be to offer special encouragement to raising and retaining new business equity—not just to preserve corporate balance sheets, but even more importantly, to enable long-term risk-taking by innovative enterprises.

Lessons from Abroad in Savings and Investment

The Japanese experience in world markets is well known. We need only to remind ourselves that from 1970 to 1978, this resource-poor country—poor in oil, in food, in minerals—still managed a trade surplus by an astonishing *increase* in its manufactured goods surplus of \$65 billion. It is enough to “disorient” one, if you will forgive the pun.

Yet the Japanese experience in savings and investment and, just as importantly, the reasons for it, seem far less well known. Many seem to attribute the whole phenomenon to the “culture” or the “work ethic”—in other words, to intangibles.

Let's look deeper. In the first place, the Japanese *need* to save more for their retirement years. Their social security and their company pensions are clearly less generous than ours and many retire early—at age 55. Second, the tax incentives to save are substantially larger and significant semi-annual bonuses are used to encourage workers to plow back earnings into “their” company. Finally, industry gets a larger share of savings, partly because housing is a less policy-favored investment. Take a few minutes to study the tables at the end of this statment, and see for yourself how much “culture” there is in those numbers and how much “bottom line”.

To be sure, attitudinal differences such as the employee's sense of identity with “his” company, are important. But there is a lot more rationality and reason than many American suspect. Put differently, I have little doubt that American workers would save much more than they do given the sorts of objective—not cultural—incentives enjoyed by the Japanese. Most important among these objective incentives is the Japanese policy of relying less on public retirement security, financed by current taxes, and

more on private, funded retirement security, financed by genuine savings. It is part of the Japanese pro-savings, anti-consumption "culture."

Now What About Savings and Investment Incentives?

The tables I attach to this statement, which show a comparison of U.S. tax policies with those of our major economic competitors, are very revealing on this "culture" issue. We find that the U.S., compared with four of our largest competitors—Japan, West Germany, France, and the United Kingdom—presently extracts the greatest share of its public revenue from progressive taxes on income, investment, and property, and the smallest share from proportional taxes on payrolls and consumption. We also find that U.S. public revenue received from taxes on investment, capital gains, property, and corporate earnings presently exceeds, as a share of GNP, that of any of the other four. Should it really surprise us that our levels of household savings and of business capital formation are, as a share of GNP, the lowest—often by far the lowest? If we want to reverse this sad trend, we should look at these countries for some positive alternatives.

- Three of these four countries have no concept of taxing "unearned income." Only the U.K. shares this punitive tax with us.
- All of the four—especially Japan—grant generous personal deductions for ordinary interest and/or dividend income. France has recently instituted a comprehensive deduction for new or rolled-over investments. Our \$200 per year income deduction is pathetically small and is not a permanent tax-code provision.
- All of the four have a more or less integrated corporate tax, whereby investors receive a personal credit on dividend income to compensate for the corporate tax already paid. Not only does this reduce the overall tax on investment income, it also mitigates the "lock-in effect" and frees capital to smaller, newer enterprises. The U.S. alone has no such provision.
- All of these four have a less punitive capital gains tax. Germany has no long-term securities gains tax. Japan has no ordinary securities gains tax at all. In our unindexed system, an investor can be taxed even for a long-term loss.
- Finally, notwithstanding these personal allowances, the most recent studies indicate that our corporate tax is at least as high as in the other four countries. Assuming full distribution of earnings, ours is the highest.

These unfavorable comparisons are symptomatic of a public policy which favors consumption at the expense of savings. Reversing this policy will require a major overhaul of our tax system.

INVESTMENT AGENDA FOR THE EIGHTIES:

8. Science and Innovation, Resharpener the Cutting Edge

Much of America's original rise to world economic leadership sprang from a kind of reverence not simply for science but for inventors: we literally revered our Yankee inventors beginning with the likes of Thomas Edison and Alexander Graham Bell. Whether one looks at exports, productivity, job creation, or anti-inflationary performance, every study of our economy's earlier vigor, as well as our subsequent decline, has pointed to technology and innovation as crucial contributors.

Thus, it is both curious and lamentable that so little has been said about the loss of our technological and innovative momentum in the current budget and tax dialogue about how to regenerate the strength of our economy. That this issue must be included on a list of political MEGOs is shocking.

A Lag in Technology—The Leading, Leading Indicator

Perhaps we first need to remind ourselves of some of the dreary trends in our technological and innovative performance:

- In the last fifteen years, Japan and West Germany have more than doubled their output of scientists and engineers. We are educating 5–10% fewer scientists today while, interestingly enough, the number of U.S. lawyers educated in the 1970's has grown by 83% (Chart D-3).

- While the number of patents issued to U.S. companies declined by approximately 10% between 1968 and 1978, the number of patents issued to Japanese concerns increased by 372%, especially in high-technology fields. One would expect a higher rate of growth from the Japanese, given our large base, but why should our patents decline in absolute terms? Since 1975, the number of U.S. patents issued to Japanese firms has exceeded the number of Japanese patents issued to U.S. businesses (Chart D-4).

- For technology-intense products, in which America has typically been the world leader, Japan last year had the largest absolute trade surplus of any country in the world.

- Finally, the American people recognize the historical role played by small entrepreneurial companies in our nation's growth, such as Xerox, Polaroid, Texas Instruments, Digital Equipment and Hewlett-Packard. Technologically-based small companies account for 50% to 70% of our commercial innovations and greatly contribute to our nation's growth in employment. And yet, while in 1970, 548 small companies came to the public market for funds, in 1978, there were only 29. The data for 1980 and 1981, due to the 1978 reductions in the capital gains tax, appear to be more favorable. Still, these days one has to squint hard to see the emerging Xeroxes, Texas Instruments, and Hewlett-Packards of the eighties. It is a matter requiring urgent attention.

Can we in the business and scientific communities tolerate another decade of lackluster technological performance? Can the era of the Yankee inventor be born again?

IV. Concluding Comments

To rid our economy of its excessive burdens and to find the resources we need to invest in our future, we require the leadership of this country to make an enormous, sustained political commitment.

We need leaders who are *compassionate conservatives*. Is the compassionate conservative a contradiction in terms? Can we be at the same time both socially compassionate and fiscally conservative?

Conservatism is too often regarded as the enemy of compassion. All too many still believe that the ideal conservative weapon is the neutron bomb: it destroys people but leaves property intact. We must leave that weapon behind in the 1980's, in both our rhetoric and our actions. Otherwise we shall forfeit our chance to define a common future for all Americans.

Let us be specific. There are now budget proposals that in some forms would effectively abolish the Legal Services Corporation. Granted that abuses should be corrected, every American must have access to our system of justice. Without access, there is no justice. Are we, then, not dealing here with a new but indispensable civil right? I applaud the business leaders and the American Bar Association who are stepping up to this one.

Let us consider another hyper-charged political issue: Medicaid budget cuts aimed at young pregnant mothers. These would presumably result in large increases in illegitimate children, unwanted by mothers and unwanted by society. In the grossest economic terms, almost nothing would be saved now but the future would be burdened with enormous public costs, social and economic.

We also need *passionate generalists* to counter the strong centrifugal forces in our political system. Passion is required to overcome the political obstacles to a genuine economic revival. And generalists are needed, not to comprehend every detail of every issue—that is manifestly impossible—but to put the *general* interests of the country ahead of the myriad special interests that have so distorted fiscal governance in the 1970's. The generalist leaders must learn to advance their views with as much force, color, and cleverness as the special interests.

These archetypes—the compassionate conservative and the passionate generalist—presume the *virtue of courage*. The business community too often observes, and indeed encourages, a polite collegiality of silence on issues likely to prove controversial or sensitive for particular firms or industries. For example, we are too often in favor of deregulation in the abstract but not when the free play of market forces will cause a drop of prices or profits in our own industries or in those of our customers. Selective righteousness will not win the battle of public opinion in the new decade. Nor is this battle, or the national interest, served in my view by an unwillingness of the business community to make its viewpoint understood by a President of the United States, be he “ours,” as this one certainly is, or “theirs.”

What we will need, above all, is concentrated attention on where we are going—a preoccupation with, and reverence for, the risks and prospects of the future.

So far this administration has focused (wisely, for the time being) more on the policy mistakes of the past than on any articulated vision of the future. Yet I hope none of us believes that once we have undone the errors of the 1970's, we will be able to relax once more into the stable certainties of the 1950's and early 1960's. Such a conservatism of nostalgia would not be worthy of the enormous hope and enthusiasm which the President has generated throughout the country.

Finally, then, the nation needs and wants a *contemporary conservatism*.

It is a proper role—indeed an obligation—of government to help us see our way through the future. This does not of course mean that government should “design” the future or should use micro intervention to decide the fate of particular sectors and industries. I share the distaste of the administration for so-called “industrial policies.” We lack the collective prescience to “pick winners” in the world industrial race, and we plainly lack the collective discipline to resist political pressures to prop up the losers.

But we cannot afford merely to throw up our hands about the future and say “come what may.” A policy of “laissez faire” need not imply an attitude of “we don't care.”

Demographic trends alone, for example, force us to consider the future structure of our economy. I have emphasized tonight that America is growing older. We are accumulating an enormous supply of intellectual capital and experience and we are relegating it to retirement. At the same time, the nations of the developing world are growing younger, in many cases at an alarming rate. In Mexico, for instance, 45% of the population is under the age of 15, which is simply symptomatic of the fact that almost all Third World countries are growing in population at a fantastic rate. By the turn of the century, India will have a billion people and Latin America 600 hundred million.

These trends mean that the developing nations have a large potential comparative advantage in the labor-intensive assembly and manufacture of goods. (Not incidentally, developing countries now receive one-third of our exports and are our fastest growing export destination.) We could counter this gathering competitive challenge with tariffs and quotas. Most likely, such an attempt could not last for long or with any degree of completeness. If it were effective, the almost certain result would be vast turmoil throughout the Southern Hemisphere, and the military and political consequences for the United States would be profound.

But what is the alternative? We will not solve the problem merely by cutting budgets and taxes and controlling the money supply. The alternative is to assure that the United States builds up, with equal force and speed, a comparative advantage in producing goods and services intensive in the thing we have in abundance—intellectual capital. We must become, as never before, a nation of scientists, inventors, technicians, engineers, and creative thinkers. The private sector cannot do that whole job solely on its own. The market place will not invest enough in basic research, nor can it supply needed volume and quality of scientific and technical education unless our leaders throughout the society make clear the future that we face as a people.

In this Year of the Budget, we are properly focused on what government should no longer do.

The fundamental question, however, is not simply what the government should or should not do. As we enter this new decade, the question is what the *country* should do to secure its future in a very dangerous world. No program or bureaucracy can answer this question.

Only leaders can.