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Arthur B. Laffer

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RBZ

October 2, 1992

Mr. Robert Zoellick
Deputy Chief of Staff
The White House
Washington DC 20501

Dear Robert:

A number of people have asked me why I am voting for Clinton.

On a personal level it's hard for me to go for the kill on George Bush. He's truly a nice, well-mannered gentleman. His wife is central-casting perfect and he loves and is loved by his family. All in all, he is a fine human being. Unfortunately, he has proven himself not to be a fine President.

Without reciting reams of statistics, Bush just hasn't come up to standard at home or abroad. The economy is reeling under his budget accord with Congress in 1990. And Bush is responsible for that budget accord. While I may, in fact, stand alone in believing that the tax increase of 1990 was the *sine qua non* of the current recession, I do and it was.

And Bush should have known better. He was witness to Reagan's seven fat years where tax cuts brought America 18 million additional jobs, a quadrupling of the market value of America's productive businesses and an astounding drop in both inflation and interest rates. Bush obviously just didn't get it.

But all of the evidence on the economy notwithstanding, Bush made a promise in 1988 that was far more than the usual political palaver. Again and again he reiterated publicly his solemn oath not to raise taxes or to accede to a cabal the purpose of which was to raise taxes. His pledge of "Read my lips" fame was the centerpiece of his 1988 campaign.

In 1986 when he was the Vice President, Bush promised me personally with Lee Atwater also present that he would not countenance any reversal of Reaganomics. I now believe he knowingly tried to convince me of something he himself did not believe. And he did that for his own personal gain for I endorsed him and campaigned for him at his request. This alone is sufficient to deny Bush reelection and to my screwed-up sense of values comes close to warranting removal from office on other grounds. Democracy ultimately can't survive widespread prevarication. And, George Bush is a certified prevaricator.

On the international scene Bush is the recipient of a great deal of bi-partisan praise. But even here I just don't see it that way. Saddam Hussein today thrives as Iraq's leader. And it was Bush's decision not to press the military campaign in order to depose Saddam Hussein. How can a man do a job well if he doesn't even finish it.

Bush has also positioned the U.S. as tough on Israel. I guess it doesn't matter to him or Secretary Baker that during all those years when America was sick with a bad case of national guilt and excessive state intervention, that there was only one country that never wavered in her support for us -- Israel. Israel, more than any other country, nursed us during our greatest days of self-doubt. Now that we're back to health Bush has taken the occasion to threaten our former nurse.

This surely doesn't make any sense to me, especially when you realize what the alternatives to Israel really are -- Rafsanjani's Iran, Assad's Syria, Hussein's Iraq, King Hussein's Jordan, Arafat's P.L.O. or perhaps Qaddafi's Libya! Give me a break this isn't a demonstration of good foreign policy.

Bush's trip to Japan with the auto executives was also a little embarrassing even without the unfortunate state dinner mishap. The U.S. doesn't need to beg.

The truth of the matter is Bush looked good on the international front primarily because Reagan's policies came to fruition during Bush's watch. Bush was a beneficiary of Reaganomics and Reagan's program of "Star Wars."

And, if this isn't enough the mere fact that Bush and Reagan are both Republicans gives sustenance to the detractors of Reaganomics who blame us for Bush's mistakes. Yikes! We have enough real problems without being held liable for Bush as well.

On the other side of the coin is Bill Clinton. While I do not in any way shape or form endorse him for the Presidency he surely isn't the "candidate from Hell" as one Bushie described him.

Clinton's record as governor of Arkansas is slightly above the average of other states and well above the average of Arkansas' immediate neighbors. He surely isn't a Mike Dukakis or a Jim Florio. His record as governor is a lot better than theirs. In fact, his record is a lot better than Pete Wilson's or Lowell Weicker's. Based solely on his performance as governor Bill Clinton would make a heck of a lot better president than George Bush has been (See W.S.J. 10/1/92, p. A-16).

One interesting aside on the Clinton record is that because his job creation performance was so good, the average wage in Arkansas hasn't kept pace with other states. This always happens when people are taken from the ranks of the unemployed and start working at low wages. Maybe now he'll even be sympathetic to the Reagan era. What goes around really does come around.

I'm also a little miffed at the attack on Clinton's behavior vis-à-vis the military. What Clinton did back then was standard operating procedure and not warranting the slurs that have been thrown at him. However, after four years of unfair Democratic attacks on Dan Quayle's service in the national guard there is a sense of ironic justice here. But with the enormity of the choice at hand two wrongs don't make a right.

The only really tangible material that would haringer a disastrous Clinton presidency is his *Putting People First* pamphlet. The proposals contained therein truly are horrible. If Clinton were to be successful in getting these proposals enacted they would, in short order, lead to major economic dislocations, losses in output, production, productivity, and a return of inflation. On the bright side, however, they would guarantee the election of Kemp, Symington, Weld, or Engler in 1996.

And this is perhaps the most important point of all. I cannot tell you what a Clinton presidency will be like. But, I can tell you that you'll get a great Republican presidency in 1996 if Clinton strays too far from the straight and narrow. If Bush were reelected even 1996 looks bad.

When you consider that *Putting People First* was a political document intended for the likes of those who vote in Democratic primaries it's not all that surprising that it's contents are extremely statist in nature. The tone of the Clinton campaign today is really quite reasonable -- save for his irrational fear of Reaganomics. He speaks fondly of growth as if he means it. His ads correctly chide Bush for the 1990 tax increase and so on and so forth.

All Democrats aren't bad and all Republicans aren't good. Bush is bad and Clinton just might be good. I'm voting for Clinton.



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THE EUROPEAN CURRENCY CRISIS

By Victor A. Canto and Arthur B. Laffer

World newspapers have highlighted the European currency crisis. The decision to float the British pound, Spanish peseta, and Italian lira has shaken the European Monetary System (EMS). Although numerous reasons are given for the source of the current crisis its origin can be traced to the reunification of Germany. The disturbances generated by the German union have been propagated to the other countries through the European exchange rate mechanism.¹ The real disturbances have affected the exchange rates of the EEC member countries vis-à-vis the German deutschemark. The pressures to keep up with the mark degenerated into a full-fledged currency crisis. The reaction of the member countries, including Germany's reaction, was in accordance with the workings of the EMS. However, the crisis has led to a questioning of the viability and the desirability of the EMS and proposed European monetary union.

The German Shock

There is a virtual unanimity of opinion that the reunification of the two Germanys has resulted in the recent appreciation of the DM and, hence, can be legitimately considered a source of the crisis. However, no distinction is made between the real and monetary shocks created by the union. Since they produce different effects and yield different implications it is worthwhile to review each of the shocks.

The fall of the Berlin Wall and the German reunification were presided over by the government of Chancellor Helmut Kohl. The Kohl government, although conservative, is not a supply-side government. In this regard Kohl's views are similar to those of George Bush.

The Kohl government understood that a one-for-one exchange of marks with the former DDR was overpaying for reunification. The West Germans attempted to remove the stimulus of paying too high an exchange for the East German mark and to balance the unified German budget by raising domestic VAT taxes. The convertibility of the East German mark was immediate while the tax increases were delayed. The sequence of events allows us to isolate the monetary and fiscal shocks.

The Monetary Shock: The Berlin Wall fell in November 1989. It was not until ten months later that East and West Germany united. The conversion of the East German mark into a DM at a one-to-one ratio was a clear overpayment that resulted in an excessive creation of deutschemarks. Since the disturbance in question is monetary then the purchasing power parity model would be the relevant framework of analysis. The excess deutschemarks, if unchecked, would result in a rise in German inflation, a rise in interest rates, and a depreciation of the DM.

That is, in fact, what happened. In the twelve months preceding September 1990, German consumer prices rose 3 percent. In the subsequent year the inflation rate rose to a 3.9 percent annual rate (Table 1). The DM depreciated 5 percent against the dollar and gold prices in deutschemarks rose 15 percent. While inflation was clearly on the rise, the rate of growth of the German money supply was falling. This is contrary to what the monetarist model of behavior would predict. The apparent paradox is easily explained, however, if one allows for

Table 1
German Price Indicators Before and After Unification*

Year	Percent Change in CPI Previous September Through August	Broad Money Growth Previous June Through July	Exchange Rate September DM/\$	Percentage Change Vis-à-vis Dollar	September Gold in DM	DM Price of Gold Percentage Change
1989	3.1%	5.8%	1.99		681.48	
1990	3	3.9	1.59	+20%	554.12	-19%
1991	3.9	3.7	1.67	-5	638.36	15
1992	3.5	8.4	1.39	+17	497.97	-22

*November 9, 1989
 August 31, 1990

Berlin Wall falls
 East and West United

shifts in the demand for money. German fiscal and monetary actions reduced the "moneyness" of their money. The decline in the demand for money resulted in slower growth in the quantity of money. The tax increase was reflected in a declining stock market.

In 1992 the exchange rate, inflation and money supply growth have reversed their 1991 trend, while the stock market continues to decline. Similarly, the DM has appreciated instead of depreciated and gold prices have declined although interest rates have risen and broadly-defined money continues to rise. The implications of monetary analysis (i.e., excess money creation) are not satisfied, one must search for an alternative explanation.

The Real Shocks: The reunification of the two Germanys offers the prospect for a higher standard of living for former East Germans. The full increase in living standards, of course, will not be instantaneous and there will be a transition where some time will lapse before the integration is complete.

Introduction of a market-oriented policy in the East will increase the after-tax rate of return to the factors of production located there. In short, the West German takeover of East Germany is analogous to a phased-in tax rate cut. The similarities with the U.S. experience with the phase-in of the Reagan tax rate cuts are striking. The U.S. economy experienced a major slowdown during the 1981-82 period of the tax cut phase-in. The German slowdown and stock market decline are documented in Table 2. While the date at which the Reagan tax rate cuts became effective was known with precision, January 1, 1983, the date at which German integration will be complete is not so precisely known. Nevertheless, the parallels between the two periods are worth exploring.

First, the transition period for both countries resulted in a slowing of the respective economies. The U.S. slowdown was largely due to the phase-in of the tax rate cuts. The German economic slowdown may be attributed to increases in the VAT tax rates enacted by Kohl as well as to the transition to a single German economy. Second, in Germany today, as in the U.S. of

Table 2
German Economic Indicators Before and After Unification*

Year	Percent Change in Industrial Production Previous August Through July	Percent Change in GDP Previous 3Q Through 2Q	Interest Rates Short	Interest Rates Long	Stock Market Index	Stock Market Change Over Previous Year
1989	8.4%	4.9%	7.8%	7.3%	2036.9	37.5%
1990	5.1	3.4	8.4	8.9	1966.7	-3.5
1991	3.8	4.3	9.2	8.7	1934.1	-1.7
1992	-2.5	1.1	9.7	8.1	1544.6	-5.2

*November 9, 1989 Berlin Wall falls
 August 31, 1990 East and West United

a decade ago, the prospect of future growth resulted in a relative excess demand for goods and services. The real rate of interest rose relative to its long-run level. Just like the U.S., the German yield curve became inverted (Table 2).

The bright future of the German economy has resulted in an increased demand for German marks. As a result, the exchange rate appreciated and the quantity of money driven by the higher demand resulted in a rise in the quantity of money. The U.S. had a similar experience during the early 1980s: an inverted yield curve, and a recession during the phase-in period, high real interest rates and rapid growth of M2, accompanied by a decline in the U.S. inflation rate.

The terms of trade effect induced by the first Reagan tax rate cut goes a long way toward explaining the behavior of the foreign exchange value of the dollar. The reduction in the top personal income tax rate in the U.S. to 50 percent from 70 percent resulted in an increase in after-tax returns in the U.S. to 50 cents from 30 cents, a 20 cent increase for every dollar earned by those in the top bracket. In other words, the after-tax rate of return in this bracket in the U.S. increased 66 percent.

If the U.S. and its trading partners were truly on a price rule, exchange rate changes would solely reflect a fluctuation in the terms of trade. Absent tax rate reductions by our trading partners, the foreign exchange value of the U.S. dollar was expected to increase 66 percent. On a GNP weighted basis, the foreign exchange value of the dollar increased 60.7 percent from 1980 through the end of 1984. The magnitude of the increase was consistent with the tax-induced terms of trade effect.

In earlier papers we have argued that real shocks would cause temporary deviations from purchasing power parity.² In the U.S. case there was a temporary deviation from purchasing power parity that lasted about seven years. The dollar appreciation lasted approximately five years and the return to purchasing power parity took two years. There is no reason to suspect that the German appreciation will be any shorter than the U.S. experience.

The EMS: The exchange rate mechanism is designed to eliminate divergent monetary policy and therefore adds additional noise to the system. The appreciating DM pushes the other currencies to their lower band vis-à-vis the DM. Therefore, if a country has a below-average inflation rate, it will experience currency appreciation. The EMS specifies an intervention mechanism in such circumstances. The country with the appreciating currency is required to intervene to increase its money supply (i.e., depreciate its currency).

Symmetrically, countries with a depreciating currency will be forced to reduce their money supply, thereby reducing their inflation rate and arresting the currency depreciation. The process will stop only when the exchange rates are aligned within their parity band.

The exchange rate mechanism, as it stands, suffers from two major flaws.³ First, as long as all countries inflate at the same rate the exchange rates will remain unchanged. Clearly then the ERM lacks a mechanism that will limit the member countries' average inflation rate. The solution to this problem would be to link the ECU to a commodity basket.

President Bush, in his recent speech to the world financial officials called for using such a commodity basket.⁴ The President's proposal is a step in the right direction. The U.S. experience points to the benefit of a price rule, even if it is not a *de jure* price rule.

Such intervention would force Germany to contain DM appreciation and would force the rest of the EEC member countries to reduce their money supplies. As a result, their currencies would appreciate relative to the dollar.

The EMS mechanism forces countries with depreciating currencies, UK, Spain, and Italy, to reduce their money supplies. Germany, with its appreciating currency, is required to increase its money supply.

However, the intervention mechanism forces all the countries to alter their monetary policies in a counter intuitive fashion. For example, Germany, with its zeal for fighting inflation and monetarist leanings, is concerned that the German money supply is growing at a double digit rate. To us the quantity of money in Germany is rising because of demand not supply. The attempt on the part of the German central bank to reduce the supply of money will be nocive to the German economy. Yet, in spite of their reservations, the Bundesbank did intervene along the lines required by the ERM.

A second problem with the ERM is that it was not designed to accommodate real exchange rate (terms of trade) changes. Tax rate cuts and reunification cause exchange rate appreciation over and above purchasing power parity. If countries are required to maintain their exchange rates within a band, a tax rate cut in one country will move that country's currency toward the upper end of the band. The domestic monetary authorities, therefore, will have to inflate to prevent currency appreciation. That was the case of the United Kingdom in the mid-1980s,⁵ as well as Spain in the late 1980s.⁶ Both countries experienced a rise in their inflation rate as they prevented their currency from appreciating above the target level.

Alternatively, the burden could be placed on the other countries. They could be required to prevent their currency from depreciating. In that case, as pointed out by Milton Friedman in his recent *Wall Street Journal* article, other countries would have to reduce their money supplies.⁷ Alternatively stated, the rest of the EEC countries would have to deflate. Friedman proposes a different solution: adopting a floating exchange rate with a domestic quantity rule. His rule would, in our view, lead to an increased sensitivity to shifts in the demand for money.

As an alternative, we would propose a monetary system similar to that used successfully in the United States during the 1980s: a domestic price rule and a floating exchange rate. That way the exchange rate will reflect any changes in the terms of trade. The domestic price rule produces lower inflation and lower interest rates.⁸ Of quite some interest, President Bush has just called for an international price rule.⁹

The Maastricht Agreement: The prospects for a single unified European currency have created turmoil in both financial and political circles. One argument against Maastricht is that EEC bureaucrats are not elected by popular vote. This is a valid criticism but not a reason to do away with unification. The solution would be to make the Eurocrats subject to a popular vote. This will come to pass in time, national governments will not let Eurocrats dictate their actions. Direct suffrage is the proper course of action. Furthermore, we do not believe that the EEC members will continue to let the French dominate the EEC as they have up until now.

The most telling criticism of Maastricht is the impact of the terms of trade on monetary policy. That is the source of the current crisis and it is not an isolated event. Witness Texas during the collapse of oil prices. The oil price decline caused unnecessary deflation in Texas non-traded goods prices (i.e., real estate). If Texas were a separate country, the proper solution would have been to have a price rule that kept local prices constant (i.e., zero inflation) and allowed exchange rates to absorb the terms of trade change.

The current system is not perfect, yet in spite of its current problems, if the system is anchored properly, the benefits of low inflation may overwhelm the problems caused by terms of trade changes. The U.S. experience of the various states is analogous to such a system. The U.S. system has performed well in allowing one state to trade with another and to allow people to relocate freely.

Irrespective of what happens to the EEC, Germany's sphere of influence will continue expanding until it becomes the dominant force in all of Europe. The break-up of Maastricht will only accelerate the German domination of both the East and West.

France, the United Kingdom, Spain, and Portugal will have major decisions to make as to with which bloc they will align themselves. One can argue that the British have an affinity with the U.S./American bloc. The French will be isolated with diminished political and economic power. In short, the EEC is the vehicle through which some of the Western European countries can maximize their political and economic influence.

Implications.

- The DM appreciation can be traced to the reunification of the two Germanys.
- Early on, the dominant disturbance was the monetary shock induced by the one-to-one conversion rate. During that time purchasing power parity was the relevant framework of analysis.
- The integration is analogous to a phased-in tax rate cut. It results in a temporary violation of purchasing power parity and the exchange rate that will last for several years.
- The German recovery will begin when the integration is well on its way.

- The current crisis highlights the vulnerability of the ERM to real shocks, while the system is better than independent central banks pursuing their own monetary policies.
- The ideal is to pursue a domestic price rule and to let the exchange rate absorb the real shocks, much like the U.S. did during the Reagan years.
- The ERM intervention mechanism will induce an appreciation of the European currencies vis-à-vis the dollar.
- In analyzing exchange rates, three distinct groups must be considered:
 - a) Exchange rates of any country relative to Germany: the real shock view must be considered. Exchange rates and interest rates will move in violation of purchasing power parity.
 - b) Countries not related to the ERM will have their exchange rates and interest rates move according to purchasing power parity.
 - c) Non-German ERM will be forced to pursue a restrictive monetary policy.
- The German intervention, buying liras, showed that they are abiding by the ERM. Although the ERM forces unnecessary pain the real shock is temporary and will ultimately work itself out.
- Abandoning the ERM will weaken the intervention mechanism and lead to the demise of the ERM. The question then becomes which type of monetary policy the European countries will pursue. Insofar as they move away from a domestic price rule the result will be unnecessary fluctuations in domestic prices and interest rates.
- Insofar as the EEC countries move away from the ERM, then the strongest and most stable currency in terms of purchasing power will dominate the European currency market. That currency is unambiguously the DM.

FOOTNOTES

1. A detailed description of the workings of the ERM can be found in Victor A. Canto, "Everything You Always Wanted to Know About the European Monetary System, the ECU, and ERM, But Didn't Know Who to Ask," A.B. Laffer, V.A. Canto & Associates, December 5, 1990.
2. See Victor A. Canto, "Tax Rate Reductions and Foreign Exchange Rates," A.B. Laffer Associates, August 30, 1988.
3. Canto, "Everything You Always Wanted to Know About the European Monetary System, the ECU, and ERM, But Didn't Know Who to Ask," 1990.
4. President George Bush, "An Independent Reference Point," excerpts from his address Sunday to world finance officials in a White House meeting on the global economy quoted in *The Wall Street Journal*, September 22, 1992, p. A-24.
5. Victor A. Canto and Arthur B. Laffer, "Britain Waives the Rules," A.B. Laffer, V.A.

Canto & Associates, October 27, 1989.

6. Victor A. Canto, "European Changes: Identifying the Winners," A.B. Laffer, V.A. Canto & Associates, June 15, 1990.
7. Milton Friedman, "Deja Vu in Currency Markets," *The Wall Street Journal*, September 22, 1992, p. A-24;
8. Charles W. Kadlec, "The Price Rule," A.B. Laffer Associates, October 11, 1982; Thomas A. Nugent, "The Price Rule Vindicated," A.B. Laffer, V.A. Canto & Associates, August 23, 1989; Thomas A. Nugent, "The Price Rule Revisited," A.B. Laffer, V.A. Canto & Associates, October 17, 1991.
9. President George Bush, "An Independent Reference Point," *The Wall Street Journal*, September 22, 1992.

September 25, 1992

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A.B. Laffer, V.A. Canto & Associates

NOTES ON SEPTEMBER 15, 1992 NEW YORK SEMINAR

Recently, A.B. Laffer, V.A. Canto held a one-day seminar in New York City. Below, in paraphrased form, are the remarks of some of the speakers.

ED ROLLINS: REPUBLICAN STRATEGIST, DIRECTOR: REAGAN WHITE HOUSE

Jimmy Baker is a very talented man, Rollins worked with him in 1984 and at the White House before that. Rollins' sense is that Baker was running a front runner strategy. The whole dialogue about the debate is a perfect example of his talent. The guy who needs the debate is not Bill Clinton, the guy who needs the debate is George Bush. George Bush has to make the American public take a second look at him and they haven't done that. When Perot dropped out of the race Bill Clinton was at a peak period. He thinks what Perot did for Clinton was to carry the fight at a time when Clinton, being damaged by the allegations, couldn't have effectively carried the fight. In the April-May period Clinton was obviously fighting with Brown and others, he could not make a credible challenge to Bush and could not make the argument for change. Perot got into the race, dominated the media for a couple of months and argued for change. This obviously was the message of the country. When Perot dropped out of the race on the same day that Clinton was accepting his nomination and about to give his acceptance speech, the American public, who obviously had been focusing on change, looked at Bill Clinton. They took that second look at Clinton and the whole democratic party, and just like in October of 1980 when the public took a second look at Reagan and found him to their liking, the American public took a second look at Bill Clinton.

Americans have made up their minds and they don't want Bush, however they are not 100 percent convinced that Bill Clinton is everything that they want. Rollins thinks there is still serious doubt because of the Carter legacy, and obviously Clinton in the next seven weeks has to convince the American public that the issue isn't whether he dodged the draft in Vietnam or not but whether he's an honest man who doesn't have character flaws. That is not easy to do when you are under full-scale assault, but Clinton clearly has convinced enough voters that what he did as a young man obviously is not a character flaw but was something that happened 25 years ago because he was opposed to the war.

Bush has to make America take a second look at him and he missed an opportunity with the convention. The convention is usually when you take a second look at a president, but for whatever reason, the republicans made a determination that they didn't want a fight with the religious right wing; they didn't want a battle with part of their own party. The party decided to let the right wing have the convention and they would move out of the convention and move forward.

The president's economic speech last week was a speech he should have given six months ago. That speech obviously needs to be built on, there are some good portions of it. The economic growth portion of it is very positive, but the bottom line is that you have to drive home that growth message.

Rollins has run a lot of campaigns against the democrats. What works well for republicans and what is working well for democrats this time is broad themes. What Americans want to hear, and particularly want to hear from Bush or from Clinton, is that you hear me, you understand me, we are hurting. You understand that the economy is the only thing we care about. You understand that jobs are critical, and that jobs are critical to the young people of this country who obviously are very, very concerned about their future.

For the first time a generation of Americans may hand off a worse America to the next generation. Rollins thinks that is a concern that a lot of Americans are having today. They see significant economic debt, they see an infrastructure that has significant problems. More importantly, they see an

educational system that is failing many Americans. They see that a permanent underclass has been built up and obviously they don't see any politicians offering any road maps to get out of that -- with a few exceptions. He thinks that is what Americans want to hear about in this campaign. Instead they are hearing rumors and allegations, charges and counter charges that obviously are bothering them immeasurably. When Al Sharpton is the guy running the high-road campaign in New York, you have to be a little bit concerned. In the next seven weeks you are going to see a lot of politicians and a lot of candidates not talking about issues because they are panicing. When they are panicing and see their numbers start to slide they will run negative commercials. This will turn the electorate off even more.

When you look to the future, if Bill Clinton goes on as he is, the assumption is that he will be the next president. Rollins can't tell you what kind of a president he will be but he thinks he will be a smarter president than Jimmy Carter. This is a guy who obviously is going to be like a great many of the democrats who have been elected in the '80s. No democrat runs as a liberal any more. They run as moderates, they run as conservatives, or they run as economic growth people. When they get there, most of them who have been elected in the course of the '80s in the Senate and the House, still vote the old way. But they hide it more carefully. Rollins senses that Bill Clinton is not going to go out and be reckless or do anything that is going to create a backlash against him.

The Future of the Republican Party

The Bush campaign doesn't understand that the message that came out of the convention was not a message of inclusion -- it was a message of exclusion. Think of that as the future of the republican party, with the exception of the Reagan speech which was a tremendous nostalgic speech of hope and vision. Kemp's speech was a good speech. Mary Fisher's speech wasn't on prime time, nevertheless, it was a really good speech about how compassion and tolerance and hope ought to be the message of the republican party. That was not the message of the convention, however, and obviously there was a much sharper edge to the convention message.

Rollins talked earlier about how Reagan built a coalition. The young people who came of age in the '80s saw Reagan as a significant leader, registered for the first time, and registered republican. For that reason, the strongest element of the republican party today are the young Americans. The strongest element supporting Bill Clinton today are young Americans. In this election if we lose young voters because a) they don't like the intolerance that they saw at the republican convention; or b) see it as a party that doesn't want them in it, that doesn't like their life style, doesn't like their choice selection, then Rollins thinks it is going to be very difficult for the republicans to rebuild in the future. That is the real legacy of what is happening in this campaign.

The New Congress

Clinton is going to have a very strange political phenomenon to deal with and that is the new Congress. You could have as many as 150 new members of Congress, Rollins finds it amusing that the president keeps talking about the new Congress having a republican majority because there are going to be 150 new members of Congress. Nobody has ever bothered to sit down with President Bush and show him where most of the new representatives are coming from. Most of them are coming from old democrat congressional seats, many of whom are retiring. There may be some potential gains because of reapportionment plans across the country. However, the gains won't be important unless Bush becomes a significant candidate in the next seven weeks. The democrats will still control the Congress and may pick up two seats in the Senate which will give them a very significant margin. The democrats will either pick up 5 to 10 seats in the House or lose 5 seats, but Rollins thinks you can almost rest assured that the Congress will still be a democratic congress. He also feels that we are beginning to see the generic vote for republican candidates, because of the Bush weakness, starting to drop and drop substantially.

Divided Government

Equally as important in this election, people are starting to look at the question of divided government. Rollins totally disagrees with political scientists who tell you that people walk in and make a deliberate decision when they vote for a divided government. They vote for republicans because they see republicans with a big national policy and they vote for democrats because they care more about local districts. He has never believed that to be true and he has never found any evidence of that. What he has found is that republicans have run stronger national candidates for president and run weaker candidates at the state and local level.

Obviously the power of the incumbency is such that most of the democrats in the Congress are able to get reelected because of the enormous resource advantage they have had. But Rollins thinks that when people are asked after the fact do you like the democrat congress and a republican presidency they say yes, it makes some sense. What is starting to happen now is that people are saying divided government is a part of this problem. Quayle had better be careful when he's out there saying make a choice, give us a republican congress and a republican president or a democrat congress and a democrat president. It is almost easier to get a democrat president than it is to do the other.

Rollins sense is that you can clearly see a change in the mood of the environment of the checks and balance system of a divided government. It is not very appealing to voters today. His sense is, particularly if Bush doesn't close the gap, if he doesn't start talking about things that are relative to the people, that the potential is there, just like in 1980s, for a real republican wipeout. That is what is starting to really bother candidates as he talks to them at fund-raisers across the country.

Money is very tight in the campaign, in Rollins' home state of California where obviously there was great hope for significant gains with the new reapportionment line, republicans find themselves underfunded. Obviously, you cannot run a good campaign without resources. Equally important, the democrats have the money rolling in, can smell victory, and think there is a real opportunity for a change.

As a partisan republican he is not willing to wave the white flag yet but he is getting close. He just hopes that the president and his team decide in the next seven weeks that if they are going down, they are going to try and win this thing: do it on issues. He hopes they take the economic speech and expand it. A rerun of 1988 is not what the American public wants in this environment.

The Likely 1996 Candidates

Jack Kemp: Ed Rollins was chairman of Jack Kemp for President. Rollins said that Jack's campaign was a very undisciplined campaign, without any strategy.

Kemp definitely is going to run. Kemp today, on paper, is a very strong candidate. Jack has to be a far more disciplined candidate than he was in 1988. Jack has made a lot of friends across the country and obviously some of Laffer-Canto clients are Kemp supporters. He is no shoo-in though, In Rollins' view it will be as difficult to win in '96 for Kemp as it was in 1988. Candidate Kemp will have resources, he certainly will have coalition support but it really depends on:

- whether he will be disciplined enough to let someone else run his campaign and
- whether he will be disciplined in his speeches and
- whether he will do the things that you have to do to get elected president. If he does, he is a front runner.

Phil Gramm: In spite of his miserable speech at the convention, he will definitely run. He is a very

smart, very aggressive, very ambitious man coming out of Texas who will be able to raise \$10 million, Therefore he will have resources. He is in New Hampshire every other week and since Gramm is chairman of the Senate Campaign Committee, that committee will become the Phil Gramm for President Committee. Unless there is a debacle in the Senate he probably will take over the Senate Campaign Committee so he will have a vehicle to play quite a game. Rollins just doesn't know how he will sell when voters outside of Texas get an opportunity to vote for him.

Lamar Alexander, Jr. is definitely thinking of running. He inherits the old Howard Baker wing of the party, which wasn't a very big wing but, needless to say, Rollins thinks he becomes the moderate choice. He is a very smart guy. He has taken the Secretary of Education job and created a political organization probably as good as any across the country. He clearly has his goals and objectives of how he plans on running for president.

Bill Weld is a new type of republican. He is strong on economic issues and a moderate liberal on social issues. His views may fit with the American public. He may be closer to the public's views than a lot of republicans would like. Rollins likes Bill very much and feels he is a first-rate governor and he is doing something he never thought any republican governor in Massachusetts could do: Remain popular and be on the way to a second term.

Pete Wilson: If there is any life for people when they come back from the dead in California then Pete Wilson has a chance. Obviously he will have a very difficult time of getting reelected governor. However, if he did, for some reason, and the California economy came back, you have to put him back in the game.

Bob Dole: Rollins would not rule out Bob Dole. In spite of his age Rollins feels that Dole has big ambitions and he thinks that Dole certainly is going to have all the media attention that he wants. Obviously Ronald Reagan made it possible for men in their seventies to be president.

Carroll Campbell: The young governor of South Carolina is a first rate guy -- Rollins wouldn't rule him out. Rollins felt that Campbell probably is a better vice presidential candidate but if Bush loses there will be some play there for Carroll Campbell.

Dick Cheney is another one who would like to be president. If Baker runs, Cheney will certainly have a more difficult time running. They are very close friends and allies. Cheney will have a more difficult time if he's not in the cabinet. Rollins felt that if Malcolm Wallop doesn't run for reelection, Dick Cheney could go back home to Wyoming and become the Senator of a western conservative state. Obviously with the name ID he has he is always a potential future candidate, certainly, a vice presidential candidate.

Other Potential Candidates who have ambitions but may never be able to make it include a couple of former governors, Jim Thompson and Tom Kean. Bill Bennett obviously would like to run yet it is very difficult to run from a think tank in Washington. Pat Buchanan has every intention of running again. Rollins feels that this was Pat's year to be in the limelight without any focus from any other competitors. Obviously he won't have that luxury four years from now.

Pete du Pont is struggling with what he should do with his life and Rollins would not be surprised if he got back in it.

DEREK SHEARER: PROFESSOR OF PUBLIC POLICY AT OCCIDENTAL COLLEGE

Occidental College is Jack Kemp's alma mater and Professor Shearer reports that while Jack was a student there he was a stellar football player but never took an economics class from Oxy's very fine economics department. Jack later claimed that was why he has such a clear understanding of the economy. It is a view that Professor Shearer doesn't entirely disagree with..

Professor Shearer believes the issues the country faces are very serious, they are long-run problems. It is not merely a matter of who has the best short-run fix to get us out of the current recession. He thinks it is a much more serious question about what kind of policies the country will require in the next century and how those policies are related to a vision of American society in this new world economy and in this new post-cold war world.

What he tries to do at Occidental with his students is to teach what he call the "real world." Sometimes the class is called "Applied Politics." He actually modeled the program after PP & E, the major at Oxford: Politics, Philosophy and Economics. It is a program where he brings to bear various insights from different disciplines and looks at the way the world really functions and, in particular, how business functions. He stated that he has always felt that standard economics is too theoretical and doesn't start enough from the practical ground level of how businesses operate. He believes himself to be a very practical person and has been involved in starting businesses, has sat on the board of businesses and views himself more as an entrepreneur than a serious academic or professor.

People like Shearer who are viewed as critical of the economic policies of the last decade or critical of the current state of American society are somehow seen as arguing that America is in decline or that somehow our best days are behind us. He does not think America is in a decline but he thinks there are serious problems that need to be faced up to. That does not mean that you think America is no longer the most democratic society in the world or no longer the top economy or no longer the top military power. We are no longer the sole economic super power. We are, in fact, all of those things. But there is serious concern about the direction in which we are headed.

That is obvious to most of you. It is almost a truism. But what it means is that, relative to other countries, we are not necessarily number one in everything. That is the nature of our economic future: we have to realize we have serious competitors. That does not mean we are going down hill but it does mean we have to pay a lot more attention to competitiveness issues. These are not trivial or trite issues.

Uncertain Economic Future

The other side of this declinist question is what is happening here at home. The fact that we are no longer the sole economic super power raises questions about what kinds of domestic policies we can engage in at home and what are social outcomes at home. There is a great malaise that goes beyond economic statistics because when you look at the hard numbers, it is not that Americans are terribly worse off then they were ten years ago or four years ago, it is just that they are not terribly better off. In some cases people have been just standing still and there is the possibility that many of our children are not going to be as well off as we are. So the prospects for the future often seem bleak or confusing to people regardless of the facts. That comes about because there has been an increase in social problems; an increase in inequality. You can argue about the statistics but it is fairly clear that the rate of economic change that has been going on in the last ten years, not necessarily because of false government policies, has more to do with changes in the world economy that were exacerbated in effect because government policies did not deal with them, has affected people's lives.

People see and feel economic distress and dislocation and people, including middle management and white collar workers who lose their jobs and are faced with losing their health care, are not sure what the prospects are given the unemployment rate. They are very nervous and upset. So economic reality to most Americans is not terribly pleasant and he feels that, in fact, that is the driving force behind this election regardless of all the rhetoric and charges and counter charges. Economic reality is probably on the side of change and running against George Bush. It may not be the deciding factor but it certainly is a very big one.

Professor Shearer finds many aspects of our current society at the moment unpleasant. He does not like to see people out of work or unemployed, He doesn't like the level of violence. In the city of

Los Angeles, every weekend there are anywhere from 10 to 25 murders, usually of young people. People sense that there is something wrong, some social cohesion that is lacking. It is not just a matter of getting macroeconomic policy right or fiddling with the tax rate. There is some other things going on that we need to address.

The Role of Government

Now what does he think the major economic issue is? He thinks the major economic issue is the real deficit. He does not, contrary to most economists and editorial writers think that "the deficit" is the problem. The deficit is a symptom, is too large, but "the deficit" is not the problem and balancing the budget will not solve all the problems facing Americans. The real deficit is "the investment deficit." This is the deficit that Bob Reich alluded to, we have a very serious deficit in public and private investment. If you look at the data the policies of the last 10 to 12 years did not generate the level of public or private investment that we need in this economy to turn it into an effective, efficient, and balanced economy for the 21st century. So Professor Shearer is an advocate of what he calls "investment-led growth." The way out of our current problems is a program of public and private investment in which we grow our way out of the deficit not try to balance it overnight. You cannot get out of a mess it took us 10 to 12 years to get into overnight by some magical balanced budget amendment or by inflicting more pain on the American people.

The way to deal with the deficit is to invest and make the economy more productive so as we grow we also get the kind of society that we want and the kind of economy that we need for the 21st century. Now when you do this you also have to talk about structural change and about the role of government in this society. When he looks at American history and looks at what has worked in the past he sees the fact that, in the past, there has always been a business-government partnership in the U.S. That is a historical fact. When you get the mix and balance of the partnership right, you lay the foundations for long periods of economic growth. You are all familiar with the canals, roads and railroad building in the 19th century. Some of you may know that, in fact, Wall Street itself owes its origins to the financing of the Erie Canal when a lot of little small private shops had to open up down at Wall Street to finance the Erie Canal. It is a stimulus of a public works project that helped to create Wall Street. There is an interaction between the public and the private sector. It is a natural thing in a democratic society.

Alternative Views of Capitalism

There are different ways to organize capitalism. There is no one single model of capitalism. There are different institutional bases, different cultural traits. Japan has a very successful form of capitalism but it has traits that are unique to Japan. It has policies that they worked consciously to develop. They changed their competitive advantage in the world through conscious adoption of certain government policies. They have certain social values that are rooted in their history and certain choices they made that are different from ours. We cannot necessarily adopt those here but we have to face up to the fact that they do things differently and in some cases they do them better.

Economic Strategy

You should not bash either private enterprise or government *per se* in some ideological way. We are a democratic society, we are much more democratic than any other society in the history of the world and in general we have, for all its problems, and all the special interests, a relatively democratic government and people make choices and we are always trying to get the mix right. He is convinced that we have the mix wrong now and that we need to have an activist but pragmatic government involved in a program of investment-led growth. And so as Bob Reich suggested, and many others have written, we need an economic foundations program. Education and training are key issues and ones in which the government can play a leadership role. We have been living off public investment in infrastructure. There is a similar story in every city in the country. It is true of schools, bridges,

roads, city halls and other buildings. Things that played an important role in educating people and providing transportation are falling apart. We have to rebuild and renew those things. We cannot just let them run down and crumble. It is also a jobs program. You can put people to work in the private sector, because again it is the people who build the schools, who build the roads, who build the bridges, it is not the government; it is private enterprise. The government gives the stimulus of the funding and in some cases you can do joint funding. You can mix private and public money in some kind of national infrastructure trust. There are creative ways to do it but the important thing is to have some kind of national infrastructure program.

An infrastructure program, along with education and training are the most important things that the government ought to do. We need to be ready for the 21st century so America has to be "a learning society." That means we have to really take education seriously. And that goes from full funding of head start at the beginning to using our school facilities at the end for older people for literacy training. But in between we need to work out programs so that people who want to go on to college can afford to do it and that they can pay that money back. People ought to pay back their loans but they ought to have a choice. They can pay it back from a percentage of their income or they can pay it back through a national community service trust program. For students who are not inclined to go to college we need a national apprenticeship training program. Germany has a very successful one as many of you are aware, it is important that kids who have manual or technical skills but aren't necessarily oriented toward college have options for success. As Bob Reich said, in the new world economy in large part what you earn is based in large part upon what you learned, on how flexible you can be, how you can learn new skills. The odds are, for most kids graduating school today, that they are going to change jobs three to five times. If they haven't had a good base in education they are not going to be able to contribute or compete.

Professor Shearer called for "a national economic strategy." This is not central planning, this is not industrial policy *per se*, this is not picking winners. This is simply thinking strategically about the future of the American economy and its role in the world and trying to figure out what government does well and what it doesn't do well. In the post cold war era, we know that there are better ways to create incentives for private investment and there have been very good proposals about target investment tax credits, about targeted ways to deal with capital gains, so that the benefit actually goes to people who are starting new businesses and investing in new businesses. There are a lot of things we can do on the incentives side and there are a lot of things we can do in spreading knowledge more widely. One of the ideas has been proposed in the new Cuomo Commission Report on the future of the American economy, a result of bi-partisan business, labor, and academic groups that Governor Cuomo called together. The idea is a manufacturing extension service, something similar to the agricultural extension service that was very, very successful in making American agriculture the most successful in the world.

The idea is that the best practices in manufacturing can be spread and learned through an extension service, through training, through joint business and university centers. There are a lot of creative ideas about turning cold war government labs into joint business-government partnerships. There are some very creative and smart people in technology working on that now, trying to figure out how you don't engage in mega projects, how not to engage in what some people call technological pork barrels. You want to figure out how to do smaller discrete projects, spread out resources, make best use of your lab facilities, and out of that kind of approach, get results that go directly into private industry. We can do it. We also cannot expect the government to have all the answers and solutions.

There have to be reforms in not only local and state government but in the way private enterprise operates. There is a general agreement among many economists and thinkers that one of the problems facing the American economy is the short-term horizon of many investment decisions made by private corporations. This is not something that the government, by itself can magically deal with, but it is a very serious issue.

Labor Versus Capital

Finally, there are interesting developments in the ways people are working. The old world of labor and capital has changed in the United States: it is part of the old growth model of the 1950s and '60s when the American economy was number one in the world and we didn't have to worry too much about international competition. Now we do. That is that the trade movement is not a major factor, not a creative force in American life, it is on the defensive, it's not quite sure if it has a future, and if so, what future. But within that somewhat sad future there are some seeds of change in interest. The old Berlin Wall between labor and management in many instances, is coming down. There are some very interesting experiments in teamwork economics. One of the most interesting is the Saturn plant in Tennessee where the union and the GM management worked together from day one to design from the bottom up a very efficient, highly productive production unit that, as best we can tell, has produced one of the best American cars in a decade. The J.D. Powers survey earlier this year ranked the Saturn number three behind two Japanese cars. It is a very interesting approach and experiment and there are other firms that are trying a sort of teamwork approach to management trying to work out a kind of American style of Japanese or German management. Again, we cannot adopt the German co-determination model and there is no way we can all become Japanese and adopt their corporatist model, but there is a way to develop a uniquely American teamwork model. This is best practice. An American administration could talk about and encourage such experiments in development. A national administration cannot require it or make it happen. But it can speak about it.

It is the type of management that works best with educated workers. The old model is not the best way to manage Americans any more. This teamwork approach seems to be working. There are also a lot of interesting experiments in employee ownership and participation. The more you can get employees involved in the actual ownership of the firm the more they have a stake and the more they are willing to take a longer term horizon about the firm, about changes that may be needed in work rules and about longer term investment needs of the firm. Again, there is no magic bullet but there are a lot of very interesting developments going on amidst what seems like a somewhat sad economic picture.

The Environment

There is also a lot of innovative thinking going on as regards the economy in "green economics." There are a lot of very intelligent and smart people who understand that jobs versus the environment is a false choice. It does not have to be one or the other. You do not have to sacrifice the environment to get economic growth. You do not need to have cancerous economic growth, but the choice is not no growth. You can have more balanced growth and there are people who are trying to do this. In California there is a lot of interest in how companies can bring these values inside the company in their decisions. It is possible for the "invisible hand" to have a green thumb. There is no inherent contradiction between the market and the environment if we get policies right. Professor Shearer is modestly hopeful about all these developments. They are not intellectual ideas that come out of the universities, these are practical developments that come out of the business community, labor, and places where people are thinking about new ways of working, thinking and innovating.

The International Scene

Shearer is guardedly optimistic about these issues if we have the opportunity to talk about them and to put them forward at a national level. He is also guardedly optimistic about the international scene. We stand at a really interesting period in American history, something akin to the period after World War II. As Dean Acheson said in his memoirs, *Present at the Creation*, we are now in a post cold war world. It gives us all kinds of opportunities but it poses all kinds of very difficult challenges at the international level: how to create new international institutions that deal with international economic environmental and political problems. These are the issues that the next administration will have to face up to. There are lots of opportunities and potential for increasing world trade.

We have the potential for a world-wide economic boom if we can handle the transition of the former Russian states and Eastern Europe and the incredible, burgeoning, growing, Chinese economy into the world economy. The potential market for goods from American companies is immense. The potential for world-wide economic growth is immense. But the potential for ethnic strife, disaster, environmental degradation, ethnic wars like we have seen in Yugoslavia, is also large. In order to get the economics right we are also going to have to get the politics right.

Professor Shearer doesn't think America ought to be the world's policeman but the world needs a police force. It is going to be very difficult to figure out how to craft that. Is the UN an adequate vehicle? Should we bring Japan and Germany into the Security Council and make them part of the genuine UN peace-keeping force or do we need some super power, Germany, Japan, America, Europe coalition to take care of that? We have to figure that out. It is going to be very tricky to figure out how to make Japan behave more like a regular and responsible player in the international arena. Japan is an economic super power and a political midget. It is still resting under the cold war security the United States provided for it all these years. It has not yet decided exactly what role it wants to take, whether it is going to go it alone, whether it is going to build its own Asian trading bloc or whether it is going to remain in partnership with the United States. At the present time the United States has no Japan policy and the crafting of a new Japan policy will be an essential element of any new administration.

The opportunities to get it right are fairly good. The opportunities for America to have economic growth at home and abroad are quite good, but they have to be built on a strong foundation. If we don't build this foundation of education, and training, we are not going to have a cohesive American society. Professor Shearer feels that the Los Angeles riots were a warning signal. We have to have social cohesion in our society. If we don't get that right we will face further difficulties. If we are not strong at home, economically and socially, ultimately we cannot lead abroad. This is the link that escapes the current president. There is now an intimate link in this post-cold war world between our economic and social strength at home and our ability to lead abroad. If we are not strong at home we are not ultimately going to be able to be strong abroad.

WAYNE ANGELL: GOVERNOR OF FEDERAL RESERVE SYSTEM

Price level stability is such an important focus for the Federal Reserve during this period of time. The Federal Reserve has such an important world-wide responsibility, and to the extent that the Fed falters or is seen to falter in their responsibility that increases the likelihood that the world may find itself in a destabilizing situation. Indeed, just last week, the narrow brinkmanship that was involved in our counterparts in Europe was there because not everyone is quite confident that the Federal Reserve is competent to be the guardian of our monetary unit.

He believes that the prospects for economic growth at this period of time are somewhat slower, somewhat different than normal. They are different because we are going through a period that is not an ordinary inventory recession liquidation cycle. The event that we are in had its beginnings, not in the 1980s, but in the 1960s and 1970s when Federal Reserve monetary policy lost its way.

The European events of this last week make it very clear that the world is in a very interdependent mix today and that events that take place one place can certainly impact very dramatically events that occur somewhere else. But the most important exchange rate problems are not necessarily those with the EMS but those between the EMS and the dollar and the dollar and the Japanese yen. In this market in which international trade is such a key for reviving economic growth, exchange rate stability or lack of stability is a very important key.

There are some in this country who act as if they would like to have exchange rate depreciation be a substitute for protectionism in the arena of world trade. Now, in his view, the greatest threat in the world today is the threat from a slowdown in world trade. He is appalled at the growing

protectionism that has occurred among the 24 OECD nations during the last 10 years. It seems to Dr. Angell that we are coming to a crossroads as to whether or not world trade among industrial nations is going to grow or whether its going to stagnate. If it is does stagnate, he expects protectionism to get out of hand. Under those circumstances monetary policy will not be able to provide the opportunity for improved welfare of people in our country and the world that we would like to see.

The Price Rule

In his presentation he asked rhetorically whether they, at the Federal Reserve, had done enough. Have we really been progressing as we should be toward price level stability? That question gets answered differently by different people. Some say that we are in a deflationary environment. Now Governor Angell is not sure how they measure deflation unless they are using asset prices as a gauge.

He believes that our country is not impacted by deflation nearly as much as it is a market system of adjustment to the worlds' savings rate that took place in the 1970s and 1980s. He believes that household savings are determined, in the long run, by real after tax rewards to savers. In the 1950s and '60s we had such low rates of return on real after tax rewards to savers that we ended up with what you would expect, rather low household savings rates. He believes that the event that we are in today would have had, as its first manifestation, the economic slowdown without a recession in the mid-1980s. That is, he believes, the event that we are in began to manifest itself, first of all, in the rust belt areas, then in the farm states, and then in the energy-producing states. Finally, the Federal Reserve used a money growth accommodation that, in a sense stopped the asset deflation that hit middle America. Both coasts were well enough and wide enough that the money growth that took place in 1985-86 caused another round of asset inflation on both coasts and, to some extent, then the U.S. middle of the country really entered almost into a depression-like event in the mid-80s. Monetary policy offset that. Then the rebound in oil prices from \$9 per barrel to \$19 per barrel and the rebound in asset prices did in effect give us a soft landing on what was a U.S. depression event. But that asset price inflation that took place then could not be sustained with the Fed pursuing a monetary policy that was designed to recapture our progress toward price level stability.

Commodity prices showed that, in early 1977, monetary policy was way too easy and monetary policy, by fits and starts in '87 began to get back on track. Then we found that the inflation cycle that took place on asset prices on both coasts, was over so then we have the 1990s where American households in every region of the country understand that buying houses and borrowing money to do so are not necessarily the road to wealth because every section of the country by that time had experienced some decline in housing prices. That environment, together with the Tax Reform Act of 1986 that dealt with the tax deductibility of ordinary interest (not investment interest), showed itself a correction of a problem that so many people had worried so much about: household savings rates.

Savings

Today household savings rates are up or moving upwards. Now household major savings rates are not as high as household-desired savings rates. Households have a notion as to how much they want to have in terms of liquid assets and what kind and amount of debt they wish to carry. Households by and large have not moved to an equilibrium and so households desire to save more than they are now saving. But when all households try to save more at the same time it impacts incomes and impacts jobs. That danger regarding jobs causes households to desire even higher savings levels because people are saying, "My goodness, if my job is going to be lost I want to save even more." So we're in a period when household savings rates are going to continue to move up and if household savings rates continue to move up as incomes rise then the expansion that follows recovery will be muted just as the recovery itself is muted. In this environment there are those who say we have to fix our problems somehow by getting the U.S. budget back in balance. At the same time you have everyone trying to save more and at the same time our government is trying to save more. Of course, we all know that will not happen. That's why many of us of the supply side suggest that the right way to deal

with monetary problems is of course by making certain that we do not tax capital and that we do not tax labor so as to discourage growth. In doing that we have to find ourselves back on the growth posture which, in a sense, is a prerequisite for households getting their balance sheets in order and a prerequisite for balancing the U.S. budget.

September 24, 1992

Pedro Marcal

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A.B. Laffer, V.A. Canto & Associates

AN AURIC GUIDE TO MONETARY POLICY

By Victor A. Canto and Thomas E. Nugent

In light of the recent turbulence in exchange rates, one of the questions most often asked is whether the dollar is weak or the DM strong. Since one currency is quoted in terms of another, the answer is subjective. Once in a while each of us has experienced a strange phenomenon. When sitting in a train in the station, next to another train, one of the two trains begins to move. Initially, one is not sure whether the train one is on is moving or the other one is. The way to determine what is happening is by looking out the other window to see if the station is still there. If it is, then it is the other train that is moving.

This is not unlike determining what is going on in currency markets. The observer has to select a benchmark to determine what is actually happening. In the case of currencies, the price of gold in the local currency has been suggested as a useful indicator. In fact, recently President Bush called for an international benchmark to guide exchange rates.

The key issue is how to implement this benchmark. Our proposal, taken literally, suggests using the price of gold in a country's currency to evaluate that country's monetary policy. Here are the policy implications:

If the price of gold remains within a narrow price band then monetary policy is consistent with price stability. In this case, monetary policy should stay the course.

If the price of gold in local currency declines below the band then monetary policy is too restrictive (i.e., deflationary). In this case, accommodation is required. The central bank should intervene to increase the country's money supply (i.e., buy bonds in the open market in exchange for local currency).

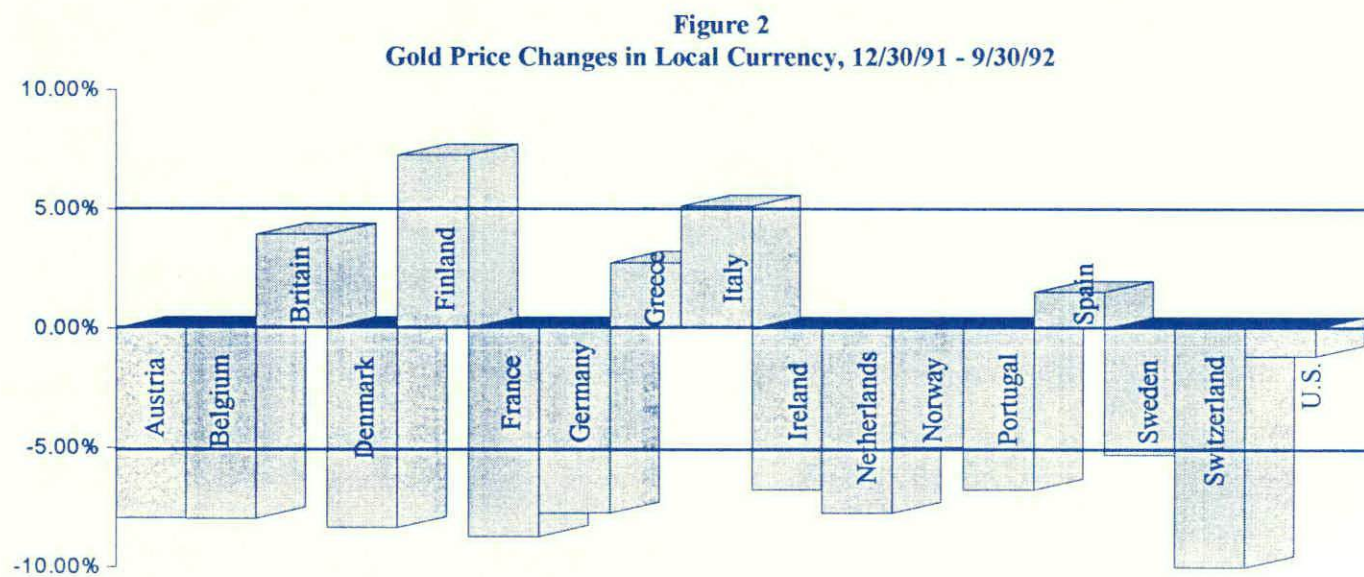
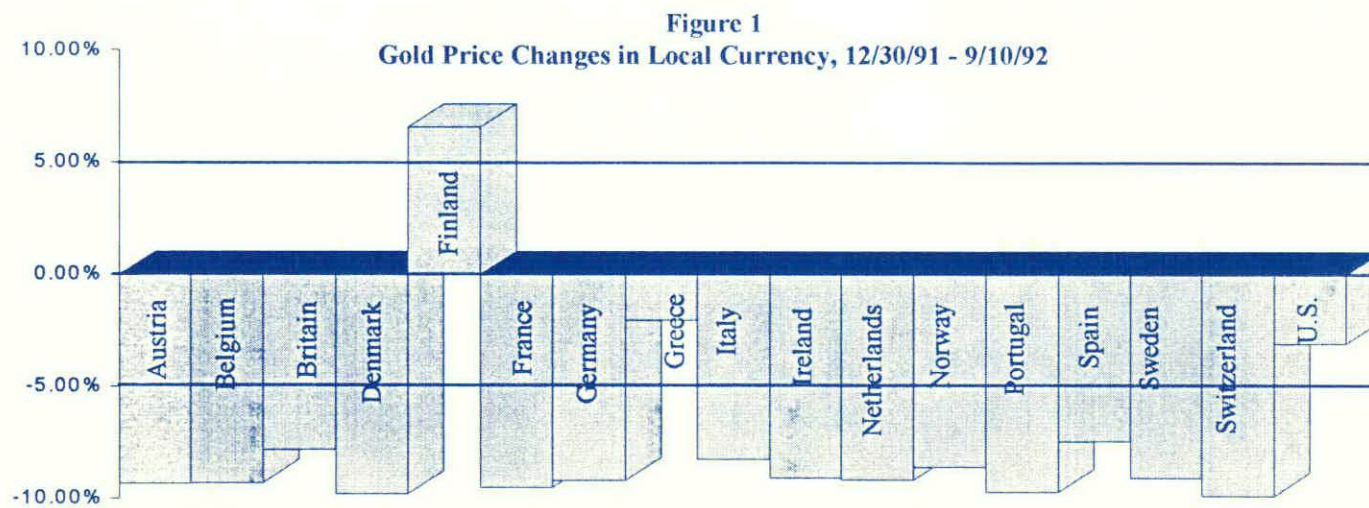
If the price of gold rises above the band then monetary policy is too lax. In this case the central bank should act to reduce the growth rate of its money supply (i.e., sell bonds in the open market in exchange for local currency).

How Good is the Auric Signal?

The percent change in the price of gold in local currency for the United States and several European countries is reported in Figure 1. Two time spans are reported: The percent change up to the European currency crisis and the year-to-date figure. The signal and appropriate policy recommendations are as follows:

U.S. monetary policy is on target. Prior to the crisis the dollar price of gold had declined 3.09 percent. As long as the price of gold stays within the target range (i.e., \$350 oz. $\pm$ 5%), no action is required by the Fed and monetary policy should stay the same.

Prior to September 11, gold prices in DM had fallen 9.21 percent. Given that German inflation during the prior year was running at a 3.5 percent rate and gold prices in



DM had been falling, it is safe to assume that the 9.21 percent decline put the gold/DM price below its target range. The golden signal suggests that German monetary policy was too restrictive. The appropriate course of action is to pursue a more expansive policy that arrests the decline in the DM price of gold.

The Bundesbank reacted to the crisis: It intervened in the foreign exchange market. Since the intervention the price of gold has risen. However, as is typical of German conservatism, the rise was less than the prior decline. German monetary policy continues to be too restrictive. The year-to-date decline in the DM price of gold stands at 7.73 percent (Figure 2).

The German effect does not stop with Germany. The restrictive German policy has led to an appreciation of the DM vis-à-vis its trading partners. Under the ERM, member countries exchange rates are allowed to fluctuate 2.5 percent from their parity rates without the countries being required to take action (the UK and Spain have a 6 percent parity band). Once the parity band is reached the countries with a depreciating currency must reduce their money supply growth to shore up their respective currencies. The countries with the appreciating currency must increase their money supply to arrest the currency appreciation.

It is apparent then that the restrictive German monetary policy played a major role in the recent currency crisis. Belgium, France, Holland and non-EEC member Switzerland, among others, attempted to keep up with the DM and consequently have adopted the German deflationary policy. Italy, Spain, and the United Kingdom broke away from the ERM in order to pursue a more regressive monetary policy. All have experienced a rise in gold prices, signaling an excessive/inflationary monetary policy. Furthermore, the excesses are such that the gold appreciation exceeds the fluctuation allowed by exchange rate parity bands.

The appropriate course of action for these countries is to reduce their money creation so that gold prices stop rising. Instead, they have chosen to abandon the ERM and pursue their expansive monetary policies. The outcome will be continued depreciation of their currencies and a higher inflation than in the other EEC countries.

Assuming that the gold price in each of the countries approximated equilibrium at the beginning of the year, the 5 percent band identifies Austria, Belgium, Denmark, France, Germany, Ireland, Netherlands, Portugal, Sweden, and Switzerland, as countries having a too restrictive monetary policy (Figure 2). On the other hand, Finland and Italy appear to have an expansive monetary policy.

The United Kingdom is approaching the upper band of expansive monetary policy while Norway is approaching the lower band signaling a deflationary policy.

Policy Recommendations and Implications

1. Each country should establish a target gold price band.
2. Intervention should take place by modifying domestic monetary policy when the price of gold moves outside of the band. The necessity for an intervention mechanism and costly maneuvers by central banks will no longer be necessary.
3. By focusing on a domestic monetary policy that stabilizes the value of a currency relative to a benchmark, the exchange rate will reflect changes in the terms of trade among countries.

4. Any deviation from the intervention mechanism by an individual country will be quickly recognized as an abrogation of currency stability. The implications of a loss of confidence in that country's monetary policy will deter any attempt to abandon this simple mechanism.
5. International financial markets will become more attractive as the uncertainty of monetary instability is removed from the decision making process. A lowering of interest rates around the world will occur as monetary instability is gradually eliminated.

October 1, 1992

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A.B. Laffer, V.A. Canto & Associates

Economic Study

THE DANISH PASS AND THE IRISH PUNT

By Victor A. Canto Assisted by Jeffrey M. Sheinbein

Since 1945, Europeans have had 47 years of peace. During that time the average Western European income has increased more than 300 percent. The European success and competition among countries forced the countries in Western Europe to be more alike. In an agreement signed in February the EC and European Free Trade Association (EFTA) agreed to create a common market between the two groups. This is clearly the next step toward integration. Last December, in Maastricht the EC member countries agreed on a plan that would produce a single European currency. However, during the month of June the Danes voted against the treaty. Although recently the Irish voted in favor of it, the EC treaty requires ratification of all 12 signers. As a result, its future is in jeopardy.

The Danish vote created a commotion in the financial community. Economists have weighed both sides of the issue. Recently, in *The Economist*, Marty Feldstein wrote against the single currency. Marty's reasoning assumes that monetary policy has permanent real effects on the economy. An alternative view, which we share, is that the nominal exchange rate simply measures the value of one currency in terms of another. The real exchange rate, or terms of trade, measures the value of goods produced in one country in terms of goods produced in another. Thus, in our integrated world economy there are both tradable goods (such as oil or grain) and non tradable goods (such as haircuts). Absent trade restrictions there is only one market for tradable goods - the world market - and only one price - the world price.

Marty views short-run changes in exchange rates as a convenient means of enhancing the competitiveness of the economy and improving the trade balance. He explicitly assumes that changes in nominal exchange rates are changes in real exchange rates. He argues that easy monetary policy lowers interest rates and induces a decline in a currency's value. This is only possible if he is talking about real interest rates. This is unfortunate since changes in nominal and real exchange rates differ in their impact on the economy much as changes in nominal and real interest rates do. If his focus of interest is the real effects on the economy, monetary policy is not the best policy instrument. A better policy instrument is fiscal policy.

A single currency could be an improvement over the current system, especially if the system is modeled around the country with the best monetary policy. By contrast, if the monetary union chose the worst central bank, clearly the countries would be better off on their own. The success of the monetary union depends greatly on the intervention mechanism specified. Only then the inflation potential of the monetary union can be determined.

A second argument in favor of a single currency is that the unified currency will diversify away regional monetary shocks as long as regional shocks are uncorrelated with each other. Under a floating exchange rate if a country prints too much money the excess money supply will result in higher domestic prices and a depreciating currency. Under a fixed exchange rate system the adjustment process is slightly different. The excess money will be exported to the country with excess demand for money. In other words, there is regional risk that may be diversified. The one that is not diversifiable is the disturbance affecting the bloc as a whole.

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THE DANISH PASS AND THE IRISH PUNT

The Background

Since 1945, Europeans have had 47 years of peace. During that time the average Western European income has increased more than 300 percent. The European success and competition among countries forced the countries in Western Europe to be more alike. The increased affluence was accompanied by a tendency toward similarity of countries' profiles such as the number of children in a family and hours of work. Over time the Europeans developed an institutional mechanism to foster further cooperation among themselves, the European Community (EC). Between 1958 and 1986 the EC doubled its membership.

The EC member countries account for approximately 70 percent of Europe's population and 80 percent of its GNP. The success of the EC countries has created two distinct calls for further integration. One is to allow new members into the EC. The benefit to the new members is the promise of a higher standard of living. The benefit to the EC is an expanding integrated market that increases the gains of trade among member countries. Proponents of enlarging the membership are called wideners by the press.

In an agreement signed in February the EC and European Free Trade Association (EFTA) agreed to create a common market between the two groups. This is clearly the next step toward integration. Several EFTA countries have recently applied for membership in the EC (Table 1).

Table 1
Countries Applying for Membership in the EC

Country	Date of EC Application	Commission Opinion	Likely Entry Date
Turkey	April 1987	December 1989	After 2000
Cyprus	July 1990	End 1992?	End of decade?
Malta	July 1990	End 1992?	End of decade?
Austria	July 1989	July 1991	1995-96
Sweden	July 1991	Mid-1992	1995-96
Finland	March 1992	End 1992	1995-96
Switzerland	Imminent	End 1992	1995-96
Norway	Fall 1992	End 1992	1995-96

Source: *The Economist*, May 23, 1992, p. 58.

Other possible candidates for membership would include the Eastern European countries. Although, on average, poorer than the EC and EFTA countries, several Eastern European countries (the Czechs and Hungary) have GDP per capita comparable to the poorer EC member countries (i.e., Greece and Portugal).

Another effect of the success of the European economies has been the move to become more alike economically in the hope of further enhancing their economic well being. This is the so-called deepening of the EC Agreement. The logical conclusion of this process is for Europe to become a single market. Equality of fiscal policies, a common currency, and freedom of movement of goods, services and factors of production will result in a single market. The EC countries were striving to that end. Last December, in Maastricht the EC member countries agreed on a plan that would produce a single European currency. However, during the month of June the Danes voted against the treaty. Although recently the Irish voted in favor of it, the EC treaty requires ratification of all 12 signers. As a result, its future is in jeopardy.

Two Different Perspectives

The Danish vote created a commotion in the financial community. Economists have weighed both sides of the issue. Recently, in *The Economist*, Marty Feldstein wrote against the single currency. He wrote:

"I am an enthusiastic supporter of the current attempt to achieve a single European market for goods and services...

...But the creation of a single market for goods and services does not require a monetary union. It is possible to have all the benefits of free trade without a common currency."¹

We have little disagreement with these statements. We clearly share these views and believe that the ideal way is to have a domestic price rule in each country and let the exchange rate reflect the terms of trade in each country. One should not, however, let the good be the enemy of the best. A single currency could be an improvement over the current system, especially if the system is modeled around the country with the best monetary policy. By contrast, if the monetary union chose the worst central bank, clearly the countries would be better off on their own.

In his argument against a common currency Marty goes on to say:

"Indeed, the shift to a common currency could actually diminish trade within Europe. It also is likely to reduce economic well being by raising future unemployment and increasing the cyclical volatility of activity within individual countries and it could cause a higher rate of inflation than the current monetary arrangements.

The Laffer-Canto View of the World

Marty's reasoning assumes that monetary policy has permanent real effects on the economy. An alternative view, which we share, is that money is only a veil. The impact of monetary policy is mostly in nominal variables such as the price level and nominal exchange rate. We do not rule out money having an effect on the real economy. However, in order to do so a linkage or transmission mechanism must be specified. In the United States we argued that with an unindexed tax code monetary policy would have significant impact on the economy. Inflation would push people into higher tax brackets. However, once the tax codes are indexed, bracket creep disappears and money becomes a veil once again.

The implications of our model are fairly straightforward:

- Inflation is a monetary phenomenon, i.e., too much money chasing too few goods.
- Nominal exchange rate changes reflect relative inflation across countries (i.e., differences in monetary policy).
- Monetary policy has no effect on real interest rates and the terms of trade.

In our framework the nominal exchange rate simply measures the value of one currency in terms of another. The real exchange rate, or terms of trade, measures the value of goods produced in one country in terms of goods produced in other countries. Thus, in our integrated world economy there are both tradable goods (such as oil or grain) and non tradable goods (such as haircuts). Absent trade restrictions there is only one market for tradable goods -- the world market -- and only one price -- the world price.

Devaluations: Changes in nominal exchange rates result from monetary policy actions and deliberate devaluations. Imagine that after a 10 percent deliberate devaluation of the dollar the price of wheat in Chicago falls 10 percent below the price of wheat in London. At that spread, trading companies would be willing to buy up the entire U.S. wheat crop and ship it to Britain. The price of wheat would rise in the U.S. and the price differential would be dissipated immediately. This creates arbitrage opportunities. And what is true for wheat is ultimately true for all other goods and services.

Consequently a deliberate devaluation in the dollar only increases the rate of inflation by the same amount. Not surprisingly, U.S. inflation increased after President Nixon devalued the dollar by 10 percent in August 1971.

Terms of Trade Effect: In contrast to a nominal devaluation, a change in the real exchange rate has real effects on the economy and need not be associated with inflation. Changes in the real exchange rate or terms of trade may result from tax rate changes, other fiscal policy actions or even oil price shocks.

For example, if the Saudis raise the price of oil relative to the price of U.S. manufactured goods, this would shift the terms of trade between the United States and Saudi Arabia. If the monetary authorities in both countries are committed to the goal of stable prices the assumed changes in the terms of trade would cause the dollar to depreciate relative to the riyal without producing a change in the inflation rate differential between the U.S. and Saudi Arabia.

The sharp reduction in tax rates implemented by the Reagan Administration during its first term dramatically increased the after-tax return on investments in the U.S. Not surprisingly, this caused a sharp increase in the demand for dollars and U.S. goods which led in turn to a higher real exchange rate.

In an integrated economy, however, arbitrage through capital flows eventually will bring the return on investments back into line and cause the real exchange rate to return to its long-run relationship with other currencies.

Recall that the dollar started its rise in 1981 when the Reagan tax-rate cuts were partially implemented and peaked in 1985 after the tax-rate cuts were fully effective. Since the subsequent decline in the value of the dollar was accompanied by virtually no inflation one may infer that the change in the foreign exchange value of the dollar was due only to a change in the terms of trade. Indeed, it could be argued that since 1985 the decline in the foreign

exchange value of the dollar, as weighted by gross national product, has simply returned the dollar to its 1980 value.

Combined Changes in Nominal and Real Exchange Rates: Of course, non-offsetting changes in the real and nominal exchange rates may also occur. When both the real and nominal exchange rates fall the resulting decline in the foreign exchange value of the dollar is inflationary only to the extent that the decline in the nominal exchange rate exceeds the decline in the real exchange rate.

The experience in the 1970s clearly illustrates this point. From 1973 through 1976, the nominal exchange rate appreciated. It then declined during 1977-78. By the end of 1978 the nominal exchange rate had returned to its 1973 level.

Although a dollar bought the same amount of foreign currency as it did in 1973, U.S. goods bought 15 percent more foreign goods in 1978. In other words, the real exchange rate appreciated by 15 percent. Consequently, there was a change in the competitive position of the U.S. economy.

Marty's World

Marty's world is succinctly summarized in the following three quotations:

"Changes in equilibrium real exchange rates are inevitable, an important part of the economic environment. For example, a substantial increase in the world price of energy calls for a currency appreciation in the energy-exporting countries and a decline in the real exchange rate of countries that import energy. Alternatively, the equilibrium exchange rate of a country may shift gradually over time because of trends in productivity and taste."

"Equally important is that an independent currency can shift the real exchange rate without a corresponding change in the level of domestic prices."

"If the demand for the products of a country falls, it will suffer lower employment and output unless wages and prices fall immediately. In practice, wages and prices adjust only slowly, so output and employment suffer."

This could be mitigated with lower domestic interest rates __ but that will be impossible if the country shares a single currency with a larger economic area. Moreover, when the exchange rate is flexible the favorable expansionary effect of low domestic interest rates is reinforced by the induced decline of the currency's value. This too is lost when a country no longer has its own currency."

In the first quotation Marty discusses his view on the real exchange rate or terms of trade effects. Notice that there is no difference in either Marty's or Laffer-Canto's view of the world regarding the terms of trade or real exchange rate. We agree with Feldstein that real disturbances, such as oil shocks and tax rate changes, affect the nominal exchange rate. That is, the terms of trade affect the nominal exchange rate but the converse is not true.

The next two paragraphs illustrate the major differences between the two views of the world.

Marty views short-run changes in exchange rates as a convenient means of enhancing the competitiveness of the economy and improving the trade balance. In the second quote he explicitly assumes that changes in nominal exchange rates are changes in real exchange rates. This is unfortunate since changes in nominal and real exchange rates differ in their impact on the economy much as changes in nominal and real interest rates do.

In fact the third quote leaves no doubt as to what Marty believes. In this last quote he is arguing that easy monetary policy lowers interest rates and induces a decline in a currency's value. This is only possible if he is talking about real interest rates.

Consider the alternative view. If inflation is too much money chasing too few goods then "easy" monetary policy will result in higher inflation and consequently higher nominal interest rates. The higher inflation will, according to our framework, result in a currency depreciation. Our model's predictions are consistent with Latin America's experience during the 1970s. Excessive monetary policy produced higher nominal interest rates and nominal currency depreciation. The opposite of Marty's prediction. The statement that a lower interest rate leads to a depreciating currency applies to real, not nominal, interest rates. Therefore, Marty is asserting that easy monetary policy reduces the real rate of return and, consequently, results in an adverse terms of trade effect. In short, he is focusing exclusively on any real effect that monetary policy may have.

If his focus of interest is the real effects on the economy, monetary policy is not the best policy instrument. A better policy instrument is fiscal policy. A tax rate cut will increase a country's after-tax rate of return and result in a terms of trade or real exchange rate appreciation. Witness the United States during the early 1980s. Thus, if the focus is how to reactivate the economy, fiscal policy is the better instrument.

Marty's Arguments Against the Monetary Union

In his article Marty develops a series of arguments against the monetary union. For example he goes on to say that:

"A currency union means, of course, that nominal exchange rates cannot adjust to achieve a needed change in the real exchange rate. The local price level must, therefore, adjust to bring about the change in the real exchange rate. Thus a 10 percent fall in the real value of a currency can be achieved either by a 10 percent fall in the nominal exchange rate or by a 10 percent fall in local wages and prices."

In the quote Marty is assuming that an adverse change in terms of trade has taken place. He then assumes that it is easier to have the exchange rate rather than the price level adjust. Implicitly he is assuming that there is downward rigidity in prices and that it is less costly to devalue the currency.

There is one point not being taken into account by Marty. The best way to offset a terms of trade effect is through a real change (i.e., a tax rate cut). Marty continues to ignore this fact throughout his analysis, especially in his Massachusetts example.

"During the 1980s the New England economy benefited from a strong national demand for the products and services in which it specializes, particularly computers, military equipment and financial services. The increased demand for these "exports" from New England to the rest of the United States caused

a rise in their prices and in the relative level of New England wages and salaries. During the decade of the 1980s, real incomes per head grew twice as fast in Massachusetts as in the rest of the country.

But now the demand for computers, for military equipment and for financial services has declined. Until there is a relative decline in New England wages and in the prices of New England's "exports" to the rest of the country the level of unemployment in New England will be abnormally high. Massachusetts has the second-highest unemployment rate among the industrial states, topped only by Michigan. To shrink that unemployment, Massachusetts wages will have to decline relative to wages elsewhere in the nation.

Slowing the growth of wages is a painful process, accompanied by a high level of unemployment, declining property values and the widespread failure of New England banks. New England could deal with the transition in a much less painful way if there were a flexible "New England dollar" that could be allowed to decline in value relative to the currencies of America's other regions.

At the risk of sounding revisionist there is an alternative interpretation of the causes and consequences of the Massachusetts experience. Marty should be well aware of this since two of his Harvard colleagues had a heated debate on the subject on the editorial page of the Wall Street Journal. The two protagonists were Lawrence Summers, formerly Michael Dukakis' economic advisor and Lawrence Lindsey, a supply-sider, formerly with the Reagan and Bush Administrations.²

Not surprisingly we side with Larry Lindsey's interpretation of the events. This alternative interpretation is as follows.

The seeds of the Massachusetts miracle were planted in 1980 during Ed King's Administration. The passage of Proposition 2½ increased Massachusetts' relative attractiveness. The demand for fixed factors in the state increased and so did their returns. The terms of trade improved in favor of Massachusetts.

In addition to the state action, in 1981-83 the Reagan tax rate cuts were implemented and the U.S. economy began an unprecedented 30 quarters of sustained economic growth. The Reagan policies provided a rising tide that lifted the U.S. economy. Proposition 2½ propelled Massachusetts to the crest of the rising tide.

In 1983 Massachusetts elected Michael Dukakis as Governor. During his administration taxes were increased and the miracle began to fade. The policies implemented by the Bush Administration have produced a national ebb tide. The legacy of the Dukakis Administration resulting in Massachusetts being at the trough of the ebb tide.

Recent actions by Governor Weld in reducing tax rates and cutting spending are pointing to a resurgence of Massachusetts.

The recent misfortunes of the state could have been ameliorated by proper state tax policy. That is the message of our analysis. The policy instrument most adequate to deal with terms of trade of real exchange rates (i.e., competitiveness) is fiscal (tax rate) policy. Monetary policy is best suited to deal with price stability (nominal exchange rates).

Another argument against the union used by Marty is the lack of revenue sharing.

"A further reason for a single United States currency is that the American fiscal system provides an alternative source of regional stabilization, making regional monetary policy less important.

When the Massachusetts economy turns down, the residents of Massachusetts send fewer tax dollars to Washington and receive more in transfers from the federal government.

Although there is nothing to prevent them from entering into a revenue-sharing union, the EEC countries have other instruments available to them for regional fiscal stabilization.

Domestic fiscal policy may be used to counter the disturbance. However, if nothing is done the absorption mechanism will produce similar results. Our research shows that a country's trade balance (i.e., net absorption of goods and services) is inversely related to the country's relative growth rate. Thus, on a relative basis, the slow growth country will be spending less abroad and the foreigners will be spending more in the slow growth country. The absorption mechanism works in a manner similar to that described by Marty's revenue sharing.

A somewhat related argument is also made:

"A single tariff-free market should encourage nations to specialize in producing those products for which they have a comparative advantage. But such specialization makes a country more vulnerable to fluctuations in demand caused by temporary changes in tastes or market conditions. Domestic monetary policy can offset these fluctuations if the country maintains its own currency but not otherwise. The use of a single currency therefore makes product specialization less attractive: a single currency would reduce the potential gains from trade."

Notice the arguments. First, a single market leads to specialization. All economics texts and arguments that we know show that in a competitive environment this specialization leads to greater gains of trade. The second part of his argument is that as you specialize, the country becomes more vulnerable to terms of trade changes. The question is what is the appropriate policy instrument to deal with terms of trade fluctuations.

Marty is either one policy instrument short or is recommending the wrong instrument to deal with issues of competitiveness.

Arguments For a Unified Currency

The compelling argument for a unified currency is also stated in Feldstein's piece.

"Some see a single currency and a European central bank as a way to restrict the ability of national governments to pursue inflationary monetary policies.

We subscribe to the above-mentioned view. How that is accomplished depends greatly on the intervention mechanism specified. Only then the inflation potential of the monetary union can be determined.

Earlier we mentioned that if the rules were such that the worst central bank were selected

the countries would be better off. In contrast, if the best central bank were selected then the inflation potential would be greatly reduced. The least potential for inflation will be achieved by a system that explicitly anchors the currency to an aggregate price.

Under a floating exchange rate if a country prints too much money the excess money supply will result in higher domestic prices and a depreciating currency. The country that prints too little money will experience the opposite effect.

Under a fixed exchange rate system the adjustment process is slightly different. If a country prints too much money the exchange rate will remain fixed. The excess money will be exported. That is, the country will suffer a balance of payments deficit. The money will be imported through a balance of payments surplus by the countries whose central bank is not printing enough.

A second argument in favor of a single currency is that the unified currency will diversify away regional monetary shocks as long as regional shocks are uncorrelated with each other. In other words, there is regional risk that may be diversified. The one that is not diversifiable is the disturbance affecting the bloc as a whole.

The Significance of the Danish Vote

The Danish referendum was a blow for the political establishment. The impact will be to slow the process toward unification and harmonization. The 1992 single market program called for the harmonization of corporate tax rates. Largely as a result of the referendum the EEC is taking a cautious approach to the harmonization of corporate taxes.

In an about face Christine Scrivener, the Commissioner for Fiscal Affairs, said:

"The priority is to reconcile and coordinate fiscal policies rather than harmonize them."³

A similar move to delay the monetary union implies that a thorough understanding of the exchange rate mechanism (ERM) is important in any portfolio or financial strategy dealing with the EEC.⁴

Understanding the European Currency Unit (ECU) and its intervention rules provides a mechanism for analyzing the monetary effects of economic disturbances in response to deviations in exchange rates from parity rates. The European Monetary System (EMS) includes an ERM that specifies ECU-related rates as well as the allowed deviation from the ECU parity rates (i.e., the parity bands).

The EMS provides a mechanism for locating the position and movement of an EMS currency relative to the other members as well as the community average represented by the ECU. All member countries' currencies have an ECU-related central rate. The Commission sets the central exchange rates of the currencies toward the ECU. These rates are kept near parity through the ERM. With these rates a "parity grid" can be established in which the bilateral exchange rates and fluctuation margins are fixed.

FOOTNOTES

1. Martin Feldstein, "Europe's Monetary Union: The Case Against the EMU," *The*

Economist, June 13, 1992, pp. 19-22.

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3. Martin Du Bois, "EC Official Backs Less Ambitions Policy Than Harmonizing Corporate Taxes," *The Wall Street Journal*, June 22, 1992, p. A-9.
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A.B. Laffer, V.A. Canto & Associates

Political Economy

IS THE CALIFORNIA TAX REVOLT OVER? AN ANALYSIS OF CALIFORNIA'S PROPOSITION 111

By Arthur B. Laffer
Assisted by Christopher S. Hammond

Propositions 111, 108, and 116 would materially raise California's tax burden: i) an additional nine cent per gallon gas tax, ii) an additional sales tax on top of the gas tax itself plus, iii) a weight tax on trucks. They would also weaken the Gann spending limit beyond the point of recognition: i) the new taxes would not be subject to the limitations, ii) capital expenditure would be excluded from the limitations, and iii) the formula for calculating the spending limits would be loosened. California would also be authorized to issue an additional \$3,000 million worth of debt and commit California's taxpayers to both interest payments and principle repayments for years to come.

If passed, Propositions 111, 108, and 116 would have a major impact on the future path of California's economy. This impact is not as the proponents would have us believe. Instead, California's growth would be lowered and within a few short years California's unemployment rate would rise by about 1½ percent above where it would otherwise have been -- all as a direct consequence of Propositions 111, 108, and 116.

Had the new limits been in effect, California would have experienced a \$10 billion gas tax increase over the 1980-88 period. In addition, changing the formula used to calculate the spending limit would have resulted in a cumulative increase in the limit of \$19.2 billion to 1990. Divided by the average population of 26 million people, it would have meant an average additional gas tax of \$385 per person and \$738 in additional spending for the state. A total of \$1,123 per person. This number does not give any consideration to the exclusion of capital expenditures from the Gann limit.

Prospectively, the impact of the propositions on the relaxation of the spending limit could result in a cumulative increase of \$53.3 billion over the next 10 years. Its passage would trigger a \$15.3 billion tax increase. That amounts to \$547 additional tax per person and \$1,882 increase in spending limitations for a total of \$2,429 per person or \$9,718 per family of four based on 1988 population. These figures underestimate the true revenue and expenditure impact. They do not account for the effect of removal of capital spending from the Gann spending limitations.

As a result of the passage of these propositions, property values will fall and California will take on the aura of its sister states, Massachusetts, Connecticut, New York, New Jersey, and Arizona, to name but a few. Property values are always the first to suffer from escalating state taxation and are among the hardest hit areas as well. Those properties associated with the longest commutes will suffer the most. The truth is precisely the opposite of what the proponents of Propositions 111, 108, and 116 would have us believe.

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**IS THE CALIFORNIA TAX REVOLT OVER?
AN ANALYSIS OF CALIFORNIA'S PROPOSITION 111**

The proponents of Propositions 111, 108, and 116 are not rigorously trained to understand the impact these propositions will have on the lifestyle of California. Nor are they broadly experienced to comprehend the magnitude of the disservice they do their fellow citizens. Undoubtedly they believe deeply in what they preach but they are just as wrong as if their statements arose from conscious deceit and conspiracy. The innocence of their ignorance does not shield California from the very real consequences of their deeds. The heat of their rhetoric belies the depth of their knowledge. In the words of Bertrand Russell:

Persecution is used in theology, not in arithmetic, because in arithmetic there is knowledge, but in theology there is only opinion. So whenever you find yourself getting angry about a difference of opinion, be on your guard; you will probably find, on examination, that your belief is getting beyond what the evidence warrants. [Bertrand Russell, *Unpopular Essays*]

To assert that additional highway funds could be used productively in California is scarcely convincing as an argument for Propositions 111, 108, and 116. To wag a finger at rush hour congestion with that all-knowing conceit is disingenuous at the least and most likely dissembling. The case for passage of Propositions 111, 108 and 116 does not measure up to the mark. Much more would have to be argued than can be argued to make the case for passage of Propositions 111, 108, and 116.

The first condition that would have to be established is the actual extent of California's highway needs. The urgency of California's needs is far from obvious, especially when compared with other states. One experience with the byways and highways of New York, Cleveland, Boston, Detroit, Chicago, or Dallas instills a great deal of appreciation for California.

But, even if more highways were needed there would still be no need to raise taxes as is proposed by Propositions 111, 108, and 116. And even if it were necessary to raise taxes, the Gann spending limit does not need to be gutted as it would be if Propositions 111, 108, and 116 were to pass.

The benefits that could reasonably be expected to result from the passage of these propositions fall far short of the costs. California will be hurt for years to come.

Propositions 111, 108, and 116 would materially raise California's tax burden: i) an additional nine cent per gallon gas tax, ii) an additional sales tax on top of the gas tax itself plus, iii) a weight tax on trucks. They would also weaken the Gann spending limit beyond the point of recognition: i) the new taxes would not be subject to the limitation, ii) capital expenditure would be excluded from the limitations, and iii) the formula for calculating the spending limits would be loosened. California would also be authorized to issue an additional \$3,000 million worth of debt and commit California's taxpayers to both interest payments and principle repayments for years to come.

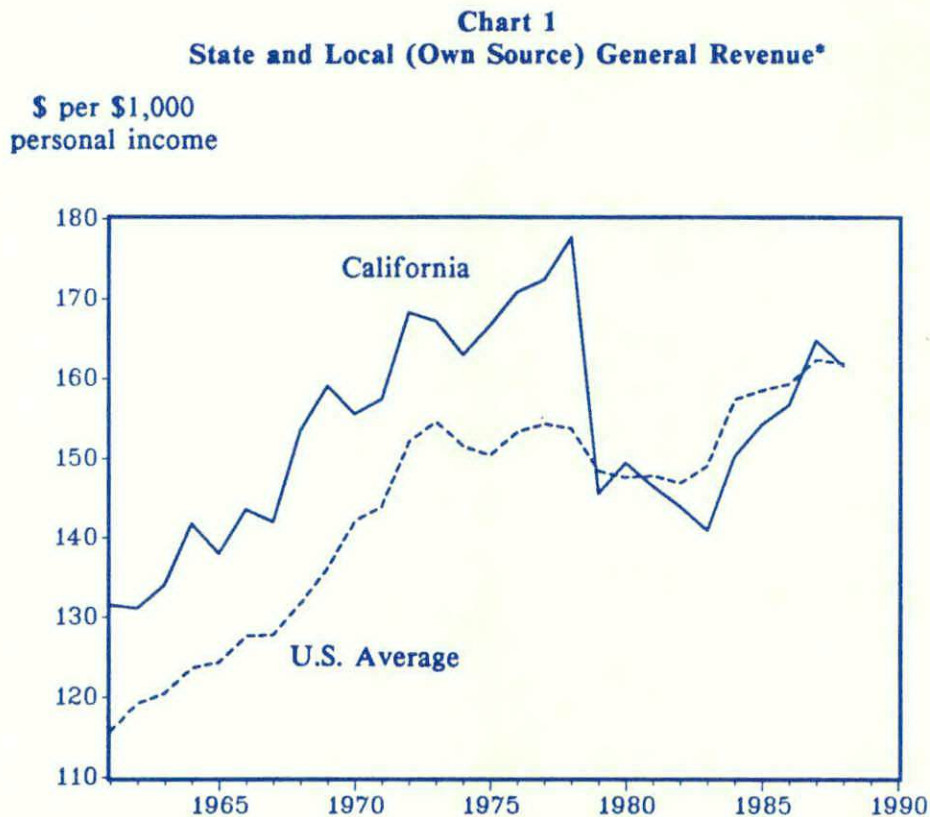
What Propositions 111, 108, and 116 promise in return is far greater state spending on highways and light rail as well as greater spending on a whole host of other state projects. There is something in these propositions for almost every special-interest group.

If passed, Propositions 111, 108, and 116 would have a major impact on the future path of California's economy. This impact is not as the proponents would have us believe. Instead, California's growth would be lowered and within a few short years California's unemploy-

ment rate would rise by about $1\frac{1}{2}$ percent above where it would otherwise have been -- all as a direct consequence of Propositions 111, 108, and 116.

Good theory is nothing if not the rigorous application of common sense predicated on comprehensive experience. And goodness knows California has experienced just about everything. To anyone open-minded enough to learn from California's lessons of the past the message is unambiguous: The power to tax is the power to destroy.

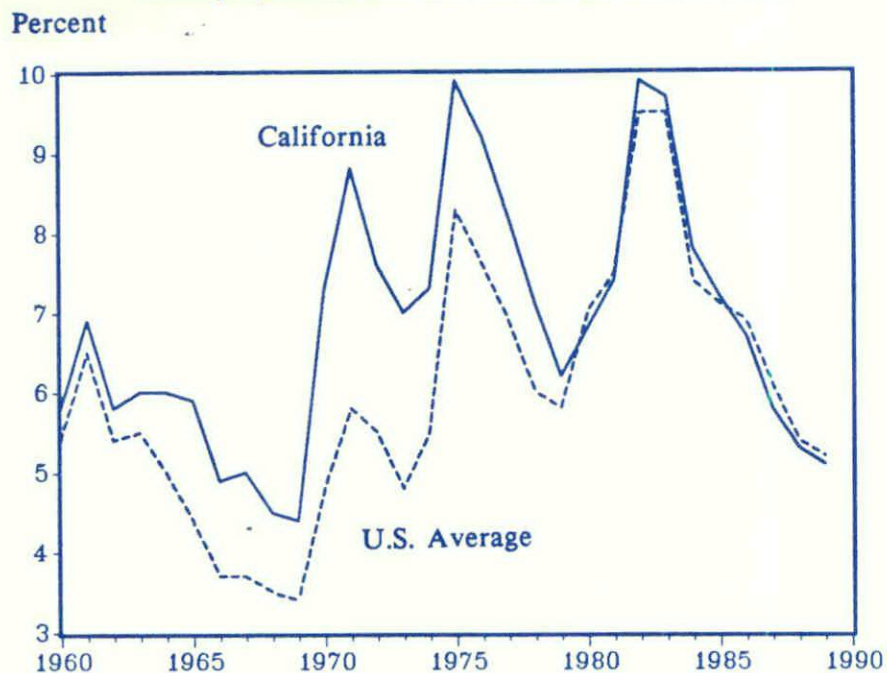
Chart 1 below plots state and local general revenues per \$1,000 of state personal income for California and the average for all states. Chart 2 is a plot of California's unemployment rate and the unemployment rate for the nation as a whole. The final chart, Chart 3, is derived from Charts 1 and 2. It is a plot of the difference between California's and the nation's tax burden and the difference between California's unemployment rate and the nation's unemployment rate.



* Excludes federal grants-in-aid, insurance trust revenue, liquor store revenue, and public utility revenue.

Source: U.S. Department of Commerce, "Government Finances" in (fiscal year).

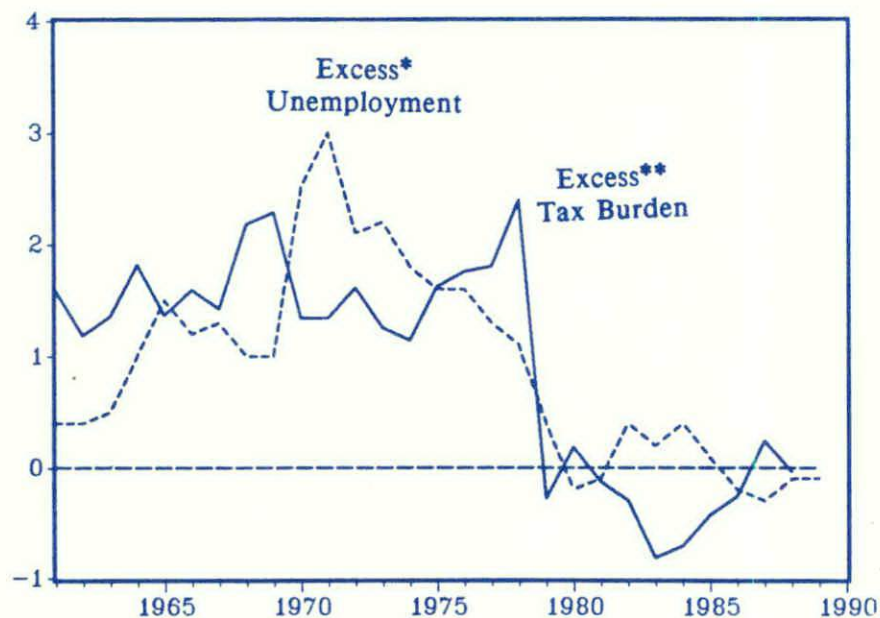
Chart 2
Unemployment Rates for California and the U.S.



Source: U.S. Department of Labor

Chart 3
Tax Burden vs. Unemployment*

Difference Between
 CA and U.S.
 (Percentage Points)



* California rate minus U.S. rate.

** California own source general revenues as a percentage of personal income minus U.S. average.

No one could possibly doubt the power of this statistical relationship. In California higher taxes mean higher unemployment.

For the U.S. as a whole there have been a number of studies documenting rigorously the negative relationship between state taxes and that state's economic well-being. These findings reconfirm exactly what happens in California. Academic study after academic study has painstakingly documented the empirical association between a state's tax policy and its economic performance. Raising the tax burden raises unemployment rates.

But as convincing as the evidence is, legislators are quick to turn a blind eye and persist in their praise of higher taxation and spending. The numbers, however, tell the true story clearly. If California undoes the tax and spending controls put in place over the past twelve years the economic prosperity of the last twelve years will stop as well. California will once again become a high unemployment state.

State Taxes and Economic Performance: The Theory

The conceptual case is equally as convincing as the evidence. Imagine two companies that sell the same products and are separated by forty miles and the California-Oregon state line. Because both companies compete in a national market that competition forces them to price their product at roughly equivalent prices. Because both companies operate in the same labor market they have to pay their employees essentially the same after-tax wages. The two companies also face similar interest charges on their borrowings and have to pay similar costs for raw materials.

Now imagine that California increases its taxes and Oregon does not. What can the California company do?

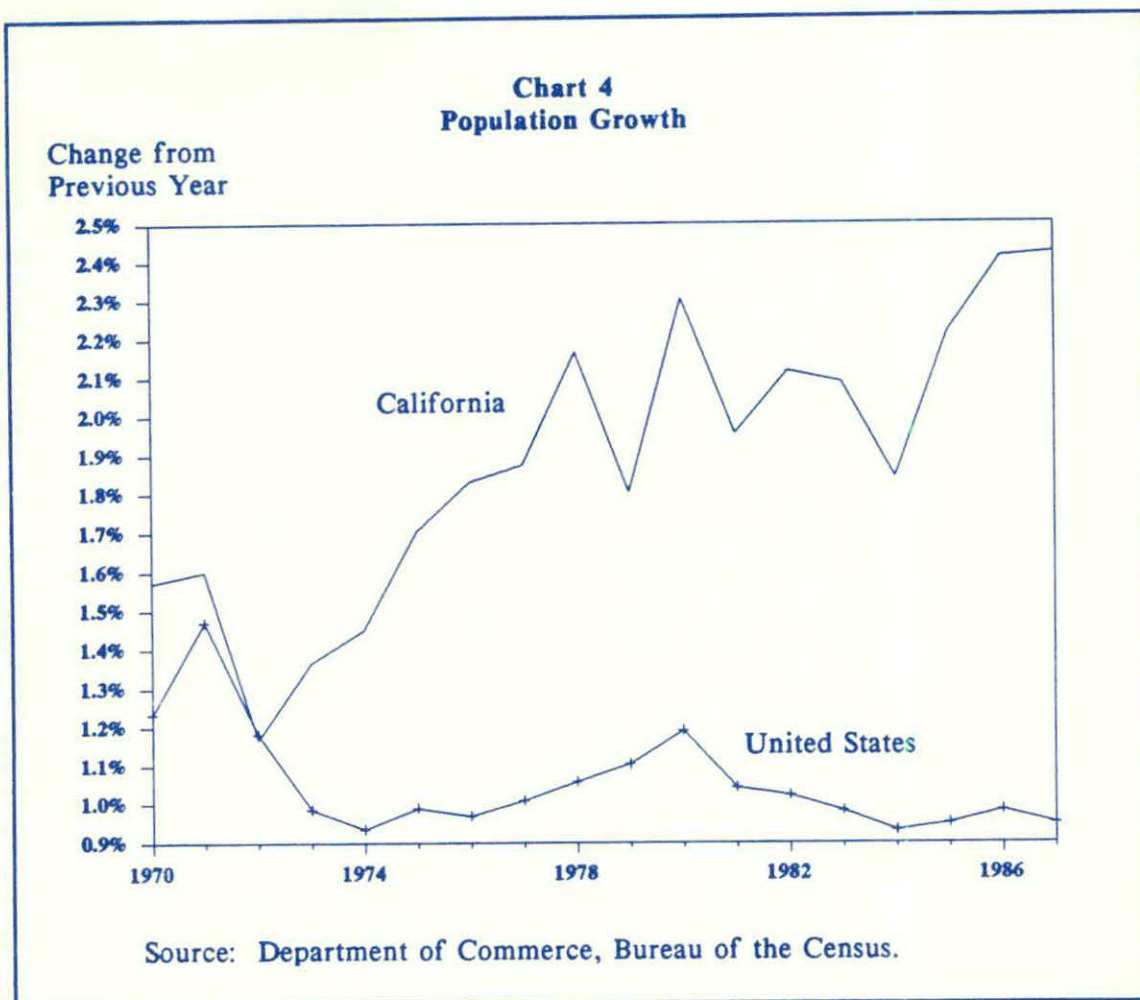
The California company cannot pass the new tax forward in higher prices or pass the new tax backward in lower wages. It will have to swallow the increased tax. In general the increased tax in California will lead to reduced profitability for the California company, reduced asset values and slower expansion.

With the passage of Propositions 111, 108, and 116 California's personal income growth, too, will fall below its potential leaving in its wake more poverty, and more problems that go hand in hand with poverty. Immigration from other states would decline as would tourism (Chart 4). It is a short step in logic to see how serious the consequences would be for most of California's real estate and construction industries.

State Taxes and Economic Performance: The Evidence

As a result of lower growth, reduced profitability and higher unemployment the assumptions underlying California's projected budget for the rest of this century will not be met. State and local tax receipts will fall short of the estimates and expenditures -- especially those to help those in need -- will exceed expectations. While these supply-side effects will take time to materialize they will, in due course, wreak havoc on the state's budget. Chronic fiscal crises mired in a sluggish economy will be the order of the day for California in the mid-1990s.

If this argument on the ultimate budgetary impact of Propositions 111, 108, and 116 seems far-fetched it is only because people are not used to thinking in terms of economic dynamics. One look at Massachusetts from "Taxachusetts" to the "Massachusetts miracle" back to "Taxachusetts" should be proof enough as to what can happen. Each state has its own unique history of taxation and economic growth but the theme underlying each and every one of



them is the same. Large tax increases are at best a short-run palliative for state budgets but are invariably a long-run disaster.

California's own fiscal history tells the same story. Back over a decade ago Charles Kadlec and I wrote an analysis of what we thought would be the consequences of Proposition 13.

"Therefore, we believe that passage of Proposition 13 could boost aggregate personal income in California \$20 billion or more above what it otherwise would be during the next twelve months; that nearly half of the income and tax revenue impact will occur within the next two years; and that the full estimated \$110 billion increment to aggregate personal income in California will be realized within ten years.

As a direct consequence of this growth in economic activity, social welfare spending should decline. The combined effect implies that California governments would, in short order, be back in surplus, and that there is little cause for sharp reduction in spending, especially for such constitutionally mandated programs as schools and essential services such as fire and police protection."¹

The analytic framework we used back before the passage of Proposition 13 was true then and it's true now. Some things never change. The passage of Propositions 111, 108, 116, and other tax increases that are bound to follow will severely damage the California economy and

will not satiate the incredible appetite of our government.

A point illustrated by the California-Oregon example is that the origins of a tax -- whether income, sales, gas, or property, etc. -- are not material in determining the overall impact on the state's economy. Quite simply the incidence of a tax is totally different from the burden of that tax. Mobile products and factors that can move quickly and cheaply will not suffer. Immobile factors, however, that cannot move easily, will bear the lion's share of the tax hike. The longer the economy has to adjust to the increased tax the greater will be the adjustment. It is hard to imagine anything less mobile than property and poor people.

As a result of the passage of these propositions, property values will fall and California will take on the aura of its sister states, Massachusetts, Connecticut, New York, New Jersey, and Arizona to name but a few (Table 1). Property values are always the first to suffer from escalating state taxation and are among the hardest hit areas as well. Those properties associated with the longest commutes will suffer the most. The truth is precisely the opposite of what the proponents of Propositions 111, 108, and 116 would have us believe.

Table 1
Percentage Change in Residential Unit Prices
From 3rd Quarter 1988 to 3rd Quarter 1989

Metropolitan Area*	Percentage Change	Metropolitan Area*	Percentage Change
San Francisco Bay	23.1%	Providence	0.1%
Seattle/Tacoma	22.5	Boston	-0.3
Honolulu	21.7	New Haven/Meridan	-2.9
Los Angeles	18.7	NYC/N. NJ/Long Island	-4.9
San Bernadino/Riverside	17.4	Phoenix	-6.1
San Diego	17.3	Worcester	-7.2

* All areas are metropolitan statistical areas as defined by the U.S. Office of Management and Budget. They include the named central city and surrounding areas.

Source: National Association of Realtors, *Home Sales*, Vol. 3, No. 10 (October 1989).

While the proposed tax increases will initially cause property values to fall, ultimately these tax increases will slow California's growth and cause higher unemployment as well. The greatest brunt will fall on those people least capable of defending themselves. Illustrations of these effects are everywhere and academic research journals are replete with the documentation of these principles. The concepts are sufficiently simple so that even a politician should be able to understand them.

Propositions 111 and 108

One aspect of the tax increase envisioned by Proposition 111 is the gratuitous dismemberment of the Gann spending limit passed in 1979. If one agreed with the central theme of Propositions 111, 108, and 116 then it would be reasonable to exclude the spending mandated by those propositions. But, there is only one reason why far greater and deeper cuts in the Gann limit are proposed. Proposition 111 is the necessary first step for an agenda of ever

greater taxes in California

The threefold changes in the Gann limit -- i) exclusion of the new highway spending; ii) re-indexing the limits to the growth in personal income, instead of population growth plus the lesser of a) U.S. CPI inflation or b) California personal income per capita growth; and iii) excluding capital spending from the limit -- will virtually destroy the restraining power of the Gann limit.

Had the new limits been in effect, California would have experienced a \$10 billion cumulative gas tax increase over the 1980-88 period. In addition, changing the formula used to calculate the spending limit would have resulted in a cumulative increase in the limit of \$19.2 billion to 1990. Divided by the average population of 26 million people, it would have meant an average additional gas tax of \$385 per person and \$738 in additional spending for the state. A total of \$1,123 per person.

Prospectively, the impact of the propositions on the relaxation of the spending limit could result in a cumulative increase of \$53.3 billion over the next 10 years. Its passage would trigger a \$15.3 billion tax increase. That amounts to \$547 additional tax per person and \$1,882 increase in spending limitations for a total of \$2,429 per person or \$9,718 per family of four based on 1988 population. These figures underestimate the true revenue and expenditure impact for they do not account for the effect of removal of capital spending from the Gann spending limitations.²

For 1988 alone, if the propositions had been part of Gann, the spending limit would have been \$3.6 billion higher. Combined with the extra gas tax of \$1.46 billion they would add \$179 per person to the California tax burden. These increases would place California even higher in the U.S. tax burden rankings: going from 11th to 8th highest based on total taxes per capita, and from 10th to 6th highest taxed state based on all own source general revenue per capita.

The impact of Propositions 111, 108, and 116 will be exceptionally onerous on the poor, minorities, and the young. Gasoline taxes are highly regressive and have their most biting impact on the poor and other disadvantaged segments of our society. While surely not done intentionally, these propositions, put on the ballot by our politicians, will be devastating to those least able to defend themselves. The conceptual underpinnings of these two propositions are just not logical. Economies cannot tax themselves into prosperity.

One of the least cogent arguments put forth by the proponents of Propositions 111, 108, and 116 is that California's gas tax should be raised because it is low by national standards. The people who argue this way simply don't understand or don't want to understand that all taxes are paid by people and that it is the overall tax burden that affects behavior. How the government takes your money is irrelevant. What matters is whether the government takes your money.

It is nonsensical to argue that because one type of tax is below the national norm it therefore should be raised unless, of course, one also argues in favor of lowering taxes that are above the national norm. The argument can't go both ways. The advocates of the gas tax increase do point to California's lower than average gas tax but shun any mention of tax categories where California is abnormally high. They never once suggest lowering any tax at any time or any where. They've never met a tax they didn't like.

The table below lists revenue sources for the State of California and the national average for all states for selected years. This table should provide the reader with a perspective on how California ranks among the states today (Table 2).

Table 2
Comparative State and Local Revenues for
Selected Revenues in Selected Years

		Total Revenues(\$MM)			Per Capita-\$	National
		1967	1978	1988	1988	Rank
Total Revenues	CA	\$ 14211	\$ 50079	\$ 120365	\$ 4251	6th
	US	107279	371607	884500	3598	highest
Own Source						
General Revenues	CA	9699	33248	79353	2803	10th
	US	76121	246368	609543	2480	highest
Total Taxes	CA	7940	27365	55169	1948	11th
	US	61241	193642	435675	1772	highest
Property Taxes	CA	4130	11011	15381	543	23rd
	US	26279	66422	132240	538	highest
General Sales & Gross Receipts						
Taxes	CA	1395	6021	14172	501	12th
	US	10143	41473	105168	428	highest
Income (Personal & Corporate)						
Taxes	CA	952	6709	17646	623	9th
	US	8062	43915	112090	456	highest

Source: U.S. Department of Commerce, Bureau of the Census, "Government Finances" (fiscal year).

There are a number of other deleterious consequences that will result from the passage of Propositions 111 and 108. In the grand scheme of things these additional consequences are sometimes viewed by economists as less weighty. Nonetheless, more of what little remains of California's open space will be cloaked in petroleum drenched asphalt. Access to what had heretofore been relatively inaccessible wild areas will be dramatically increased.

Real Solution to Traffic Congestion

What is most surprising is that the real concerns of traffic congestion are not dealt with by Propositions 111, 108, and 116. And, it is not as though we don't have the knowledge or experience to deal effectively with traffic congestion. We do.

When faced with the potential crisis of the Olympics and all the associated traffic, careful planning and imaginative execution led to a very successful control of traffic. In fact, the traffic congestion during the Olympics was probably less than during normal times. Surely California's elected representatives can do as well as they did during the Olympics and thereby avoid all the unsavory consequences of massive tax and spending increases.

Congestion is driving's equivalent of having to wait in long lines to buy a product. Save for a few industries such as chic restaurants where long lines are the *sine qua non* of acceptance,

long lines are a sure sign of poor management. The only reason long lines develop is because the product being offered is underpriced monetarily and therefore the cost of waiting in line balances supply and demand.

California's government has a history of poor management. Today the crises of California's poor management encompass a whole range of governmentally controlled products such as water, pollution, congestion, education, etc. For some reason our state government prefers rationing products at low or no cost to the user rather than pricing the product where supply equals demand. Congestion, quite simply, is the price a commuter pays for using the freeways during rush hours. Unfortunately that is a price paid by the user but never received by the state to make things better. Everyone is worse off.

The correct solution is quite straightforward -- usage of the freeways during rush hours should have a monetary price. There should be a license fee to drive in a car with no other passengers or a highway use toll to ration valuable highway space during rush hours. The concept is clear -- charge vehicles extra for using the roads where and when demand is great. A gas tax doesn't do that.

Propositions 111, 108, and 116 totally ignore one of the most powerful movements in America and especially in California today -- the slow-growth movement. Even to the vizier extraordinaire forecasting is a risky venture. And yet, if these two propositions pass and the slow growth movement gains momentum, we could experience first hand just what happens when the irresistible force meets the immovable object. The outcome of having to build freeways to the tune of the new taxes and not being permitted to build highways where people now live could be 57 lane highways stretching from one border of Yolo county to the next. The picture is not very pretty, but it does illustrate some of the critical shortcomings of these propositions.

California's *per capita* state spending on highways is literally the lowest in the nation. Even federal *per capita* spending on highways in California is way below the national average. But then again this is not a new phenomenon. The share of California's budget spent on highways has always been lower than the national average. In 1972 California spent 7.8 percent of its budget on highways while the average for all states in that year was 11.4 percent. By 1982 California's budget share dedicated to highways had dropped to 4.4 percent while the U.S. average was 8.07 percent. The most recent data for the year 1988 has California at 4.5 percent and the average for all states 7.9 percent.

Our population growth has always been higher than the national average. There is nothing new about that either. Why these conditions would now be used to justify such radical measures as Propositions 111, 108, and 116 doesn't make any sense except as rhetoric.

It makes no sense to raise taxes to increase highway spending when the proportion of our budget spent on highways is so low. If our spending needs were all that desperate, a simple redress of the abnormally small percentage of our state's budget spent on highways is readily available. It makes no sense to cut down the cherry tree to pick the last cherry.

The federal highway trust fund, as of the end of fiscal year 1989, had an accumulated surplus of \$10,551 million. The federal mass transit fund had another \$6,057 million surplus. Surely some attempt to use these idle federal funds makes more sense than raising state taxes.

Yet, in spite of California's traditional willingness to short-change highways the general consensus is that California's highways still rank among the nation's best. The problem, to the extent that California has a unique problem, stems from California's incredible success attracting people from other states. These new residents don't need to be subsidized to come

to California. They cause the congestion and they should pay for its removal.

It is neither fair nor efficient for current residents of California to pay more in taxes to build roads and highways to new housing developments. New residents should pay the full cost for coming to California. Developers surely make enough money to pay for the full costs of their developments and then pass those costs on.

Whenever ballot measures are placed on the ballot by politicians the arduous task of gathering signatures is circumvented. While clearly legal, this method of placing measures on the ballot imposes a serious political risk to the electorate at large. Invariably, compromise among competing political factions turns out to be a conspiracy against the party not included in the compromise -- the people. Propositions 111, 108, and 116 have been loaded with special interest provisions to assure as little formal opposition as is possible. There is something for every organization and political lobbying group. Propositions 111, 108, and 116 are a veritable Christmas tree bedecked with goodies and paid for by taxpayers. These compromises and giveaways have all been at the expense of the state's economic future and the opportunities afforded our young.

FOOTNOTES

1. Charles W. Kadlec and Arthur B. Laffer, "The Jarvis-Gann Tax Cut Proposal: An Application of the Laffer Curve," in *The Economics of the Tax Revolt*, Arthur B. Laffer and Jan P. Seymour (eds.) (Harcourt Brace Jovanovich, Inc., 1979).
2. *Annual Long-Term General Fund Forecast*, Winter 1989-90, State of California Commission on State Finance.

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Economic Study

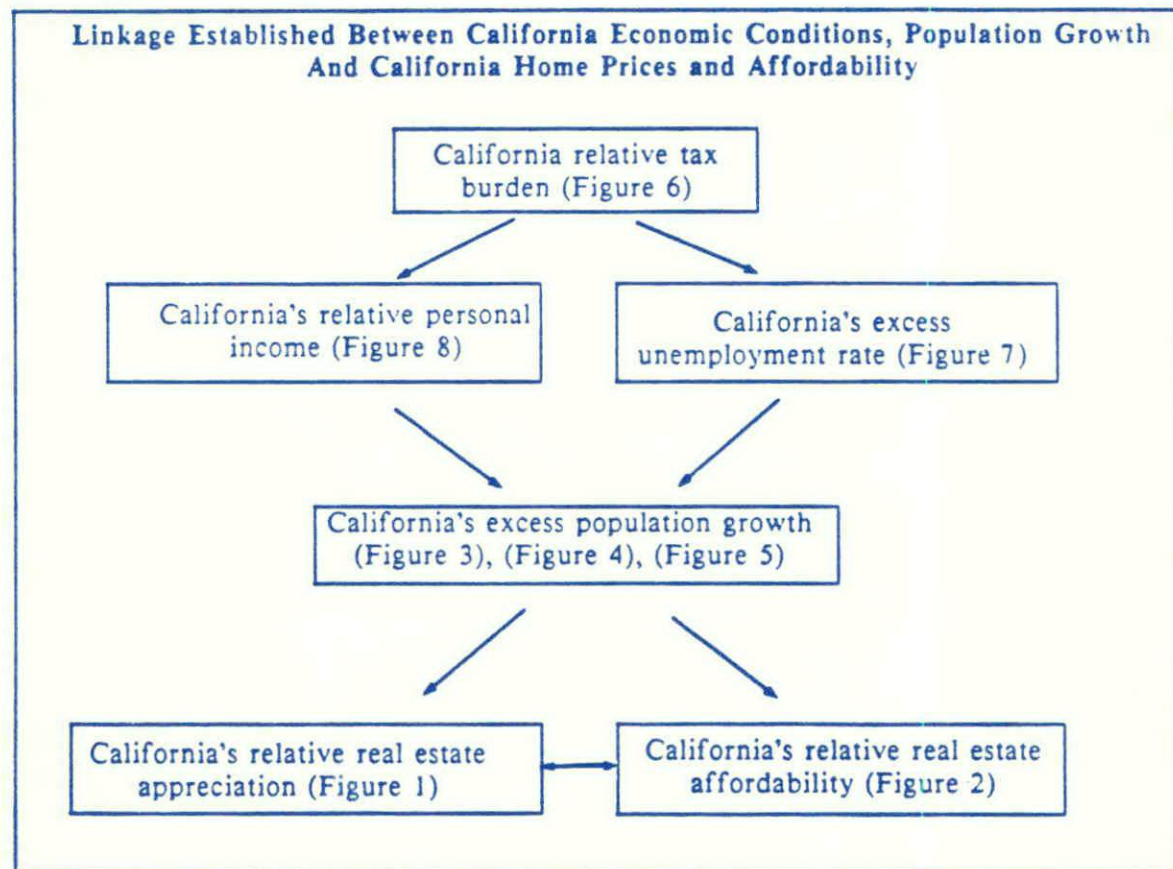
EITHER CALIFORNIA'S HOUSING PRICES ARE GOING TO FALL OR CALIFORNIA'S IN FOR ONE HELLUVA RISE IN PERSONAL INCOME

By Arthur B. Laffer and Christopher S. Hammond

California's real estate boom has been truly incredible. But as good as it has been it is difficult to view California's housing boom as either generic or otherwise impervious to human action. Serendipity is wonderful except when it is anticipated. When anticipated, serendipity is a blueprint for catastrophe.

When viewing California's real estate market the logical sequence from original cause to the final effect is as follows:

- o California's taxes affect California's business climate;
- o California's business climate affects California's population growth;
- o California's population growth affects California's home prices.



Based upon historical relationships and recent changes in California politics it is hard to visualize a continuation of California's frenetic economic prosperity, California's population growth and thereby a continuation of California's real estate appreciation. California has indeed been fortunate in the past. The elements that came together to provide California with this incredible prosperity don't seem to be likely to continue over the coming decade. As a consequence, natural market forces will lead to a fairly dramatic decline in California real estate prices.

December 28, 1990

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**EITHER CALIFORNIA'S HOUSING PRICES ARE GOING TO FALL
OR CALIFORNIA'S IN FOR ONE HELLUVA RISE IN PERSONAL INCOME**

Introduction

California's real estate boom has been truly incredible. But as good as it has been it is difficult to view California's housing boom as either generic or otherwise impervious to human action. Serendipity is wonderful except when it is anticipated. When anticipated, serendipity is a blueprint for catastrophe.

When viewing California's real estate market the logical sequence from original cause to the final effect is as follows:

- o California's taxes affect California's business climate;
- o California's business climate affects California's population growth;
- o California's population growth affects California's home prices.

Based upon historical relationships and recent changes in California politics it is hard to visualize a continuation of California's frenetic economic prosperity, California's population growth and thereby a continuation of California's real estate appreciation. California has indeed been fortunate in the past fifteen years. The elements that came together to provide California with this incredible prosperity don't seem to be likely to continue over the coming decade. As a consequence, natural market forces will lead to a fairly dramatic decline in California real estate prices.

On the cusp of tragedy is the fact that many in California and elsewhere have made large financial commitments predicated on California's continued real estate boom. Savings and loans, banks, and insurance companies all have large stakes in California real estate. Even a moderate redressing of California's real estate prices could result in a major reordering of finances. And while it is true that the underlying economy will be far less affected by a rebalancing of asset values, now is a time of major changes in the ownership of wealth. These times will be remembered for many years to come.

In the grand scheme of things housing in the near and intermediate term is a relatively fixed factor. Only at great expense can houses or other forms of real estate be transported. In the very long run however new construction combined with depreciation can relocate enormous quantities of real estate at a relatively low cost. This long-run mobility of factors all but vanishes in the nearer term.

In the case of the real estate market, the importance of long-run forces is altogether too easy to overlook. While during any day, week, month or year, long-run forces appear to be irrelevant, they do ultimately prevail over all else. In the long run, equivalent houses should cost roughly the same everywhere. Betting against these long-run forces is literally betting against "the house." You do win from time to time but the odds are not in your favor.

Whether in the long or short run, adjustments to market shocks occur through changes in price and/or changes in quantity. Increases in demand result in higher price and greater quantity. If the supply curve is elastic then the increase in price will be small and quantity great.

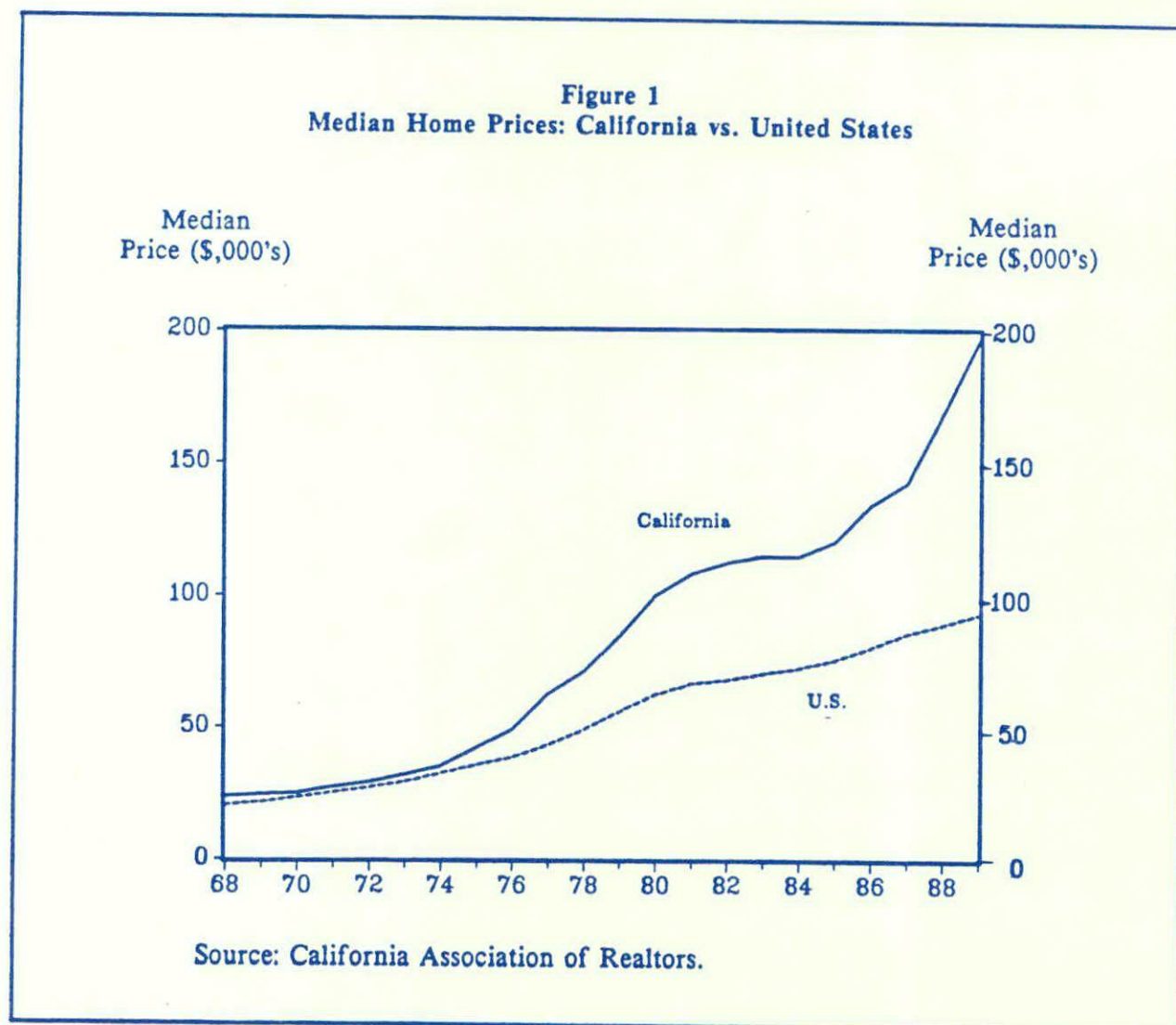
In the near term, changes in housing demand invariably come up against relatively inelastic supplies. Therefore, real estate prices provide a great deal of the buffer for near-term adjustments to changes

in market conditions while the quantity of homes accounts for less. The long-run tendency, however, is still worth keeping in mind. Over long periods of time housing prices should equilibrate across different locations. All long-run changes in locational demand should be accommodated by changes in supply -- not relative prices.

In a collection of figures I have attempted to create a picture of California. Without having to shout or draw pictures the prognosis for California's real estate market virtually jumps off the pages. Such a tendentious depiction is inherently risky. For a number of reasons I am not sanguine about California's real estate market. I believe my reasons are objective and unbiased, but, nonetheless, the reader should be well aware where I'm coming from.

California's Real Estate Appreciation

In Figure 1 the median current dollar price of a California house is plotted for the time period from 1968 through 1989 using annual data. The same data series is also plotted for the U.S. as a whole.

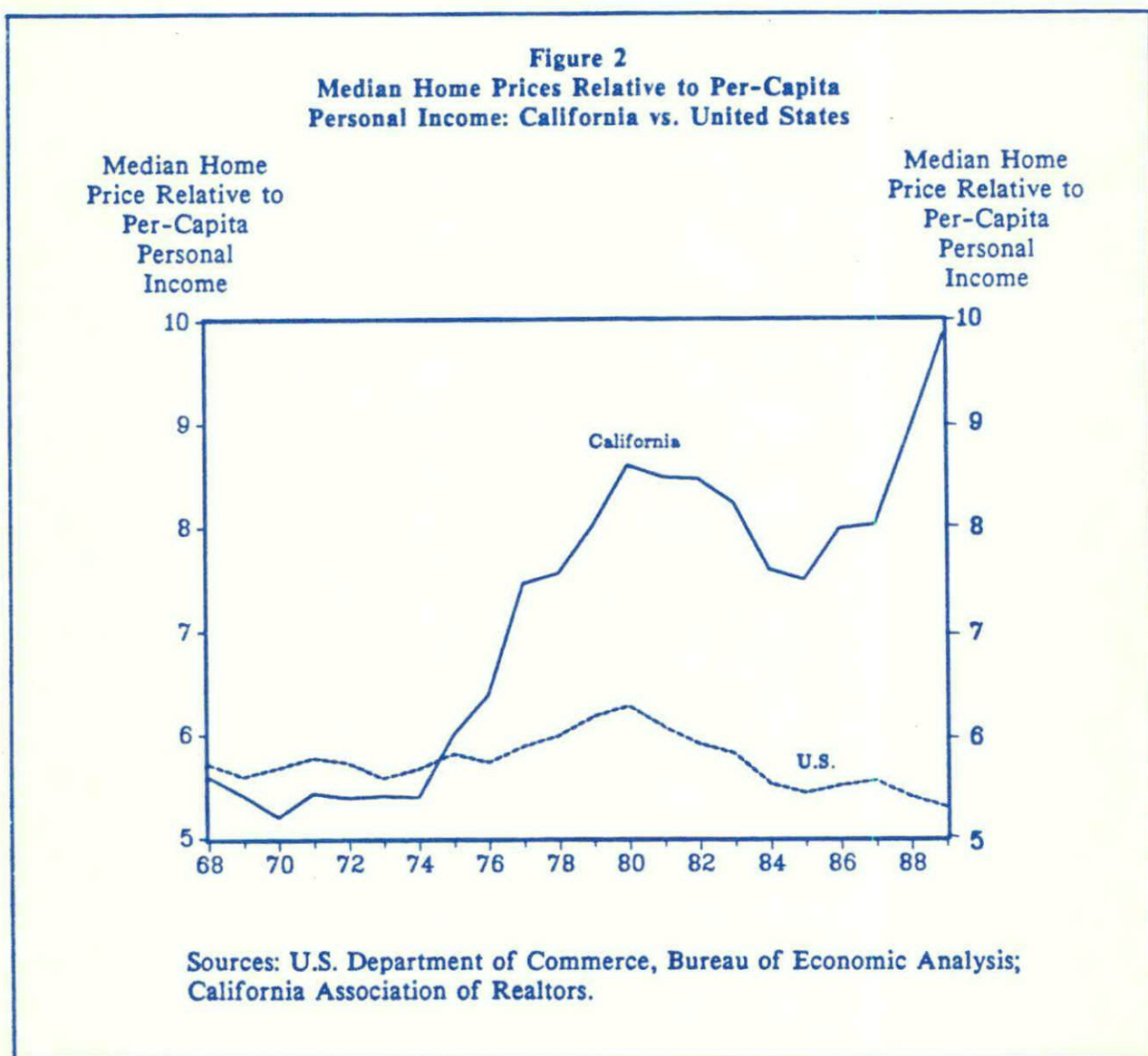


What jumps out at the viewer is how close to the rest of the country California housing prices were back in 1968 and how far they had diverged by 1989. In 1968, California's median priced house was about 16 percent more expensive than for the U.S. as a whole. In 1989 California's median priced house was well over twice that of the median priced house for the U.S. as a whole.

Income differences alone don't seem to be sufficiently great to account for such a large change in relative housing prices or the magnitude of the current discrepancy.

Housing Affordability: California and the United States

While many considerations should go into the concept of affordability, income appears to be the essential ingredient. Many measures of affordability also exist each with its own special features and nuances. Lacking universal "truth" I have chosen to relate the median house price to per-capita personal income for both California and the U.S. The shortcomings of such a measure should be obvious (Figure 2).



In spite of the inherent data problems, the differences between California and the rest of the nation are not ameliorated when personal income is taken into account. When income is taken into account California prices no longer look "out-of-line" in the 1968-75 period. In fact, for most of that period California home prices appear a smidgeon low in relation to income.

But, from 1975 on California's median housing price relative to per-capita personal income takes off vis-à-vis the rest of the country. By 1989 California's median house price relative to California's per-capita personal income nearly doubled in magnitude relative to the U.S. median house price relative to U.S. per-capita personal income.

Virtually all of the increase in this measure of "unaffordability" of California homes relative to the U.S. comes from the increase in the price of a house in California relative to the rest of the nation. Relative per-capita personal income stayed roughly the same over the period 1968-1989. In 1970, for example, California's per-capita personal income was 17 percent greater than the per-capita income for the nation as a whole. In 1989 California's per-capita personal income was 13 percent above the nation's.

For the U.S. as a whole -- if our measure of affordability is deemed appropriate -- houses have become slightly more affordable over the past thirty years. In California housing has become less affordable by a factor of almost two.

California's Housing Prices and Population Growth

Part of the change in home prices may well be accounted for by California's phenomenal population growth relative to the rest of the nation.

Because the supply of houses is relatively inelastic in the near term, immigration can reasonably be expected to have a major impact on housing prices. Not only should immigration affect housing prices in absolute terms, but also housing prices relative to income.

Over the past twenty-two years, data show a close relationship between California's excess population growth and the price of a California home. In Figure 3 below I have plotted the two series using annual data for the period 1968 through 1989. Affordability is once again the median price of a California home divided by per-capita personal income. For the relative demand for California homes I use California's excess population growth, e.g., the annual percent change in California's population less the percent change in the population of the United States.

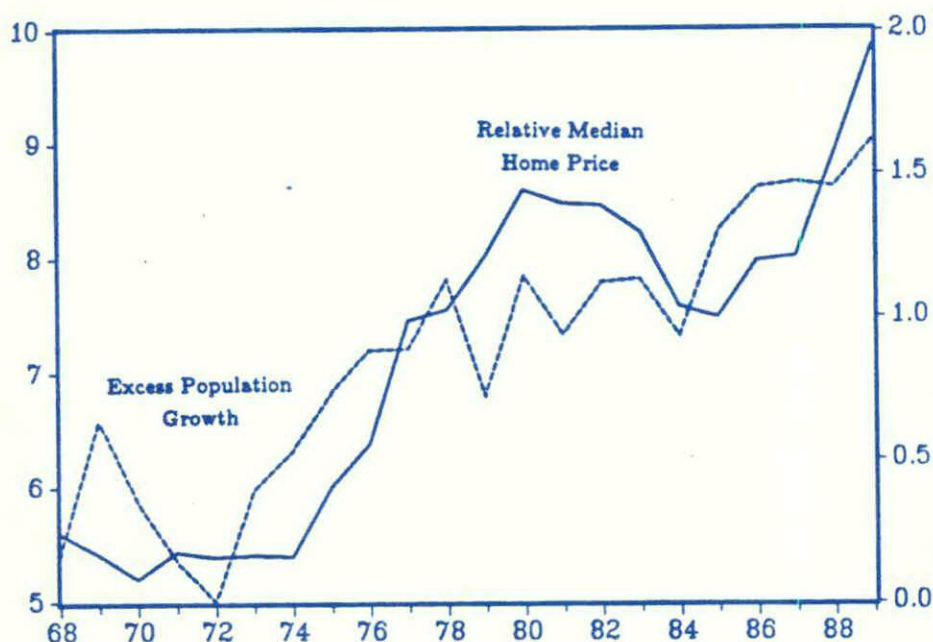
Given the crude nature of these data the statistical fit is really quite exceptional. Excess population growth goes a long way in "explaining" just why California's real estate appreciation has been so awesome.

But on closer scrutiny additional interesting features become apparent. For example, California's rate of population growth has always been higher than population growth rates for the U.S. But, back in the late 60s and early 70s the differences in the growth rates were far smaller than they were in the 1980s. The leveling-off period for differences in relative population growth rates from say 1978 to 1985 was also a period of a flat housing price "affordability" index. The latest surge in California's population growth has been accompanied by an equivalent or even bigger surge in California's home prices. As of 1989, homes in California were less affordable than at any time in recent history. Ironically, for the rest of the nation homes were more affordable than at any time in recent history.

Figure 3
California Median Home Price Relative to Per-Capita
Personal Income vs. California Excess Population Growth

Median Home Price Relative to Per-Capita Personal Income

Excess Population Growth (Percent)



Sources: U.S. Department of Commerce, Bureau of Economic Analysis, U.S. Bureau of the Census; California Association of Realtors.

So far I have restricted the time period to 1968 through 1989 solely because earlier data on median home prices were not available. For per-capita income and population growth, however, data for the entire post-war period are readily available. Unfortunately, in a readily accessible form, state and local fiscal data only go back as far as 1960. Nonetheless even a few more data add to our analytic base.

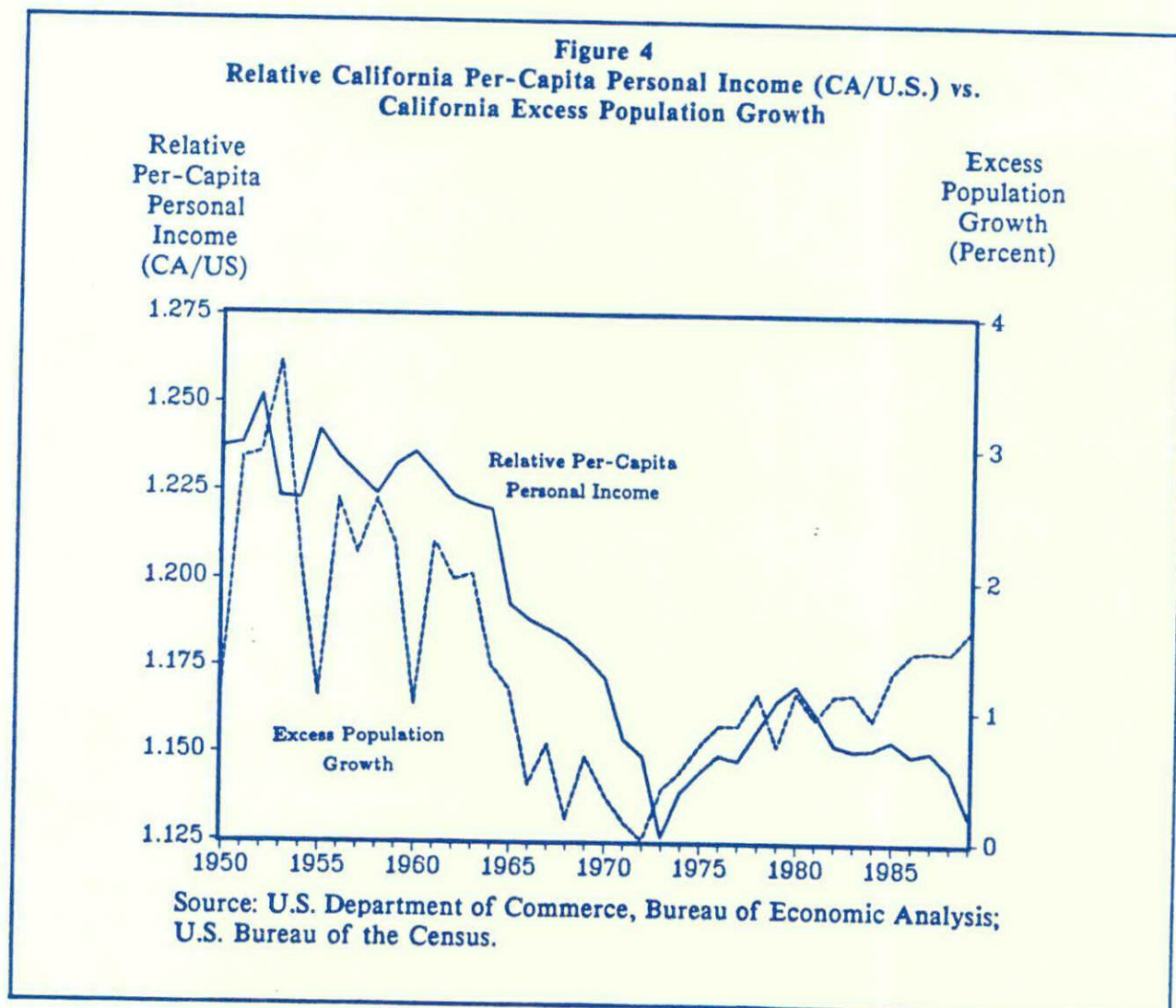
The analysis so far shows the following observations and linkages: i) California housing prices are a lot higher than those in the rest of the nation, ii) The excess rise in California's housing prices is of relatively recent origin; say, over the last fifteen plus years, iii) Even relative to income, California has experienced extraordinarily rapid housing appreciation and, iv) the extraordinary surge in California's real estate values is directly related to California's extraordinary population growth.

Economic Determinants of California's Population Growth

Taking our story the next step adds a new economic dimension. The question to answer now becomes why are people now moving to California in such great numbers? Clearly the weather, mountains, beautiful coastline and other natural endowments should have had the same siren's lure during say the 1965-1975 period as they did earlier and later. And yet California's excess population growth has shown a great deal of variation over the years.

There is no lemma in supply-side economics more powerful than the lemma that economic incentives motivate people to relocate. Imagine two locations; A and B. Then ask what would happen to migration patterns if B's per-capita income rose relative to A's per-capita income? In the absence of other extenuating circumstances B's population growth should increase relative to A's population growth. I never cease to be amazed to find that people do like to get paid. The more they get paid the better they like it.

In Figure 4 below, California's excess population growth and California's relative per-capita income are plotted for the years 1950-1989.



This longer time period reveals the true variability of California's excess population growth. Back in the 1950s California's population growth exceeded that of the nation by well over two percentage points in most years. While the average growth differential in the 1950s was high, the volatility was also very high. But some of that high volatility can be rationalized by the fact that the overall population of California was by today's standards small. California was relatively empty and yet the rest of the country was relatively full. Perhaps back then the operational constraints were different than they are now.

Back in 1950 if a million people had moved into California there was plenty of room and that million people would have resulted in a 0.71 percent decline in the rest of the nation's population. Therefore in 1950 to increase California's population by 9.37 percent the rest of the nation's population would have had to have fallen by 0.71 percent.

In 1990, California is a different world altogether. While California may not be full yet it surely is not as empty as it was in 1950. With our 1990 population of over 29 million people, to increase that population now by 9.37 percent would mean an influx of 2.72 million people or a reduction in the population of the rest of the nation by 1.24 percent. Whichever way you look at it, either from the supply side of the rest of the nation, or the capacity of California to absorb, percentage population growth was a lot easier in 1950 than it was in 1990. Therefore, while long-term population comparisons are instructive, the different time periods are not strictly comparable.

The basic conclusion must be that it will be harder and harder for California to maintain its relative population growth advantage over the rest of the nation. California is fuller and the rest-of-the nation is relatively smaller.

Figure 4 does show a strong corroboration of the basic supply-side lemma that people tend to move for economic reasons. The lemma simply makes sense and it's always nice when the data confirm common sense. Higher per-capita incomes in California relative to the U.S. are closely associated with more rapid population growth in California.

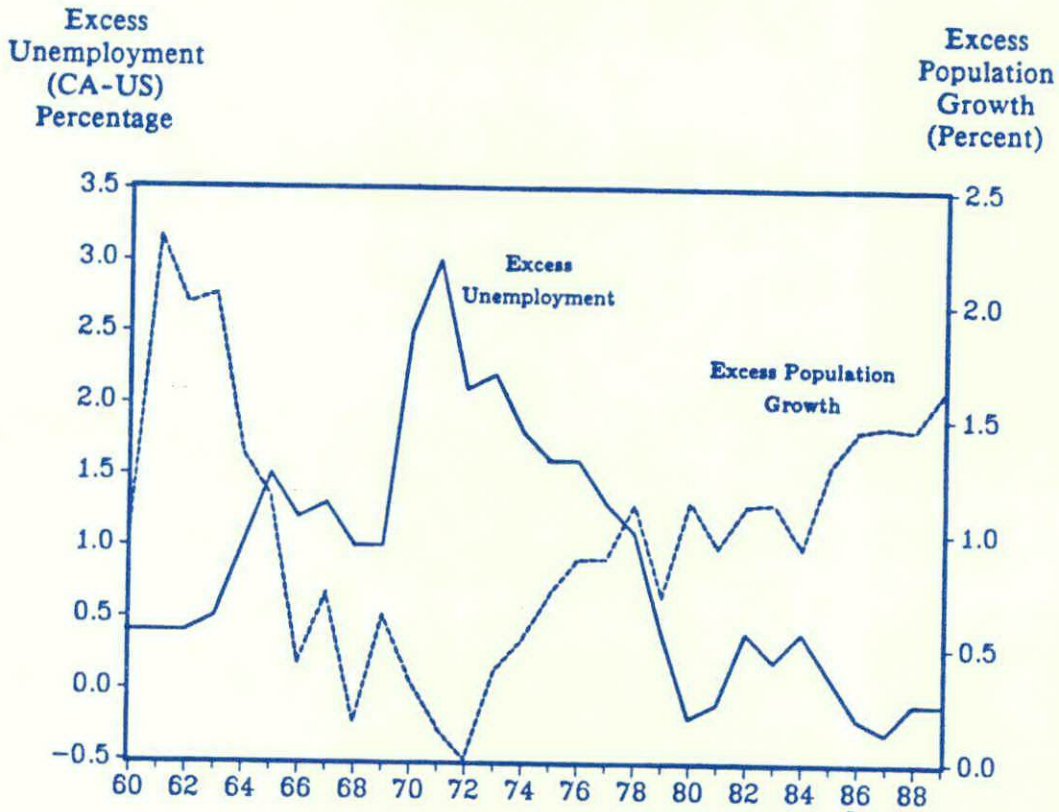
Figure 5 displays yet another version of the basic supply-side lemma that people tend to move for economic advantage. The only two differences between Figure 4 and Figure 5 are a) the time period covered; 1950-1989 in Figure 4 as opposed to 1960-1989 in Figure 5 and b) the economic advantage variable is California's relative per-capita income in Figure 4 and California's excess unemployment rate in Figure 5.

Unemployment being a disadvantage, there should be an inverse relationship between California's excess population growth and California's excess unemployment. The numbers once again confirm supply-side economic logic. Simple common sense, once again, vanquishes complex error.

Whether one uses relative per-capita income or California's excess unemployment, economics does have a role to play. No one need ever deny that non-economic factors also play roles in determining California's population growth. I'm sure they do. But what I have established is the simple proposition that California's relative population growth, in part, depends upon California's economic climate. The more jobs California has and the higher the pay for those jobs relative to the U.S. as a whole the more California's population will increase.

When added to the other propositions the logical linkages are almost complete. We now have the following:

Figure 5
California Excess Unemployment vs. California
Excess Population Growth



Source: U.S. Department of Commerce, Bureau of the Census;
 U.S. Department of Labor Statistics.

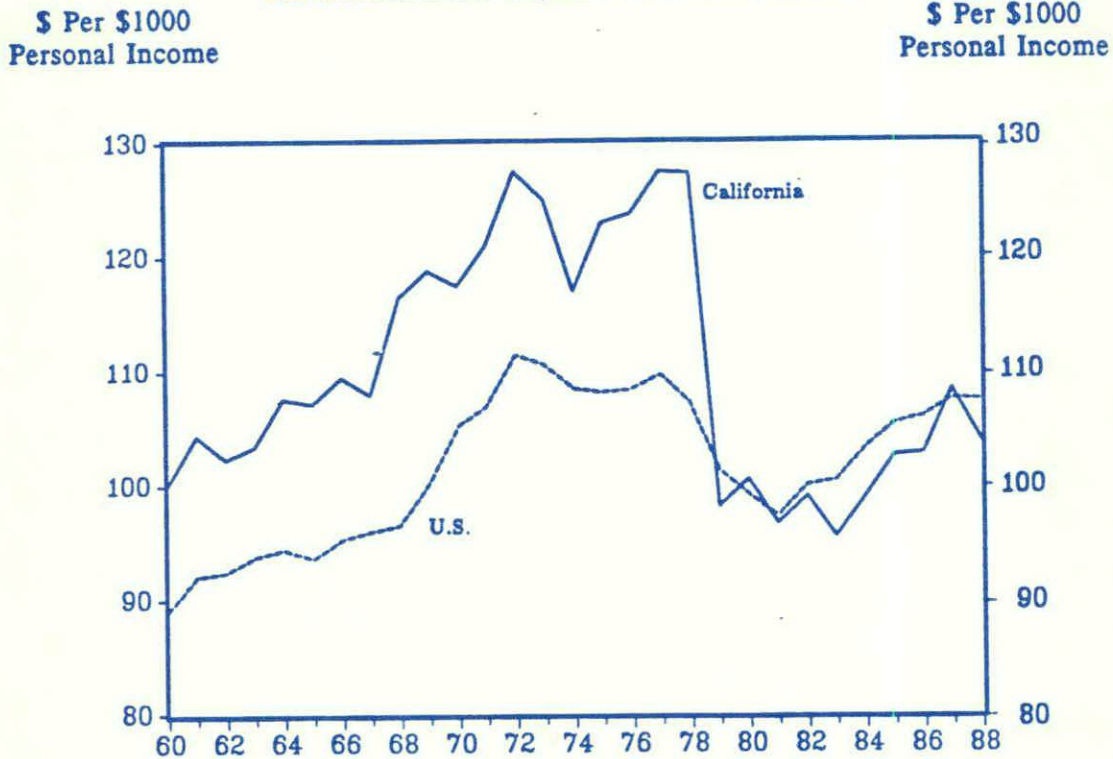
- o Relative per-capita incomes affect relative home prices (Figure 2).
- o Relative population growth raises relative home prices (Figure 3).
- o People move for relative economic advantage (Figures 4 and 5).

Taxes and Economic Growth: California and the United States

We have everything now in place save for the original cause. Economic conditions do cause migration and migration and economic conditions together do cause changes in housing prices. But what causes changes in economic conditions?

Again it is clear that a lot of factors come into play when it comes down to the economy -- whether on a national, state or local level. And even though a policy may be a national policy it still may have different regional effects. And California arguably could be near one extreme when it comes to defense spending, troop deployment or gas taxes, etc. But still it's a good bet that state and local policy differences will affect the relative performance of the different states.

Figure 6
Tax Burden For California and U.S.:
Tax Revenues Per \$1,000 of Personal Income



Source: U.S. Department of Commerce, Bureau of the Census,
Government Finances in (FY)

Take, for example, two similar companies one in California and one elsewhere. If these two companies compete in the U.S. market then a tax increase in California not shared by the company outside of California will damage the California company's ability to compete. Whether the California company tries to pass the tax increase forward on its customers or backwards on its workers and suppliers or just lowers its return on capital, the California company will be damaged.

Higher prices will make the California company less competitive. Lower factor prices and lessened returns on capital will precipitate a withdrawal from the now higher-taxed California-based company. Whichever of the effects takes place or in what combination, doesn't change the basic fact that higher California taxes render California-based companies less competitive in the grand scheme of economics. California-based companies will lose business.

With lost business there soon will be lower wages, lower profits and higher unemployment. The incentives for people and capital to migrate into California will be diminished. As a consequence, migration into California will diminish. The logical sequence is now complete.

In Figure 6 above, California's tax burden (total state and local tax receipts divided by the state's personal income) is compared to the state and local tax burden for the nation as a whole from 1960 through 1988. The reason for the 1960-1988 time interval is simply that prior to 1960 state and local tax data had not been compiled on a consistent basis and 1989's tax data have not yet been made available.

Figure 6 is incredibly revealing about California's past and present. With only a little additional information, California's future unfolds before our very eyes. From the early 1960s to the early 1970s California and the sum of all states increased taxes as a share of personal income by enormous amounts. From 1960 to 1972 California increased total state and local tax receipts as a share of personal income from 10.0 percent to 12.7 percent. In the vernacular, that is not "chopped liver" by any stretch of the imagination. During that same time period the sum of all states raised their tax burden from 8.9 percent to 11.1 percent. California once again was right at the forefront.¹

To keep everything in its proper perspective, the 1960s and early 1970s were the eras of the go-go sixties followed by the Johnson/Nixon melt-down.

The mid 1970's was a period of massive tax indigestion following the tax binge. The economy stank everywhere but was especially bad in California. From 1960 until 1978 California and the sum of all states moved together with California always having much higher taxes. In 1977, for example, California ranked as the third highest taxed state in the nation. In 1960, California was way up there on the tax charts too. From 1960 through 1977 California remained one of the very highest taxed states in the nation -- a dubious honor to be sure. But prior to the end of the 1960's, even though California's taxes were relatively very high, they had been rising sharply from a much lower base.

From the standpoint of a state's economics, a state's absolute tax burden should be important in addition to its relative tax burden. Using an extreme hypothetical illustration, if California's state tax burden were twice that of other states' and yet amounted to only two pennies per \$1,000 income the relative tax burden should have only a minimal impact on anything. The absolute tax burden would be so small as to dilute the relative tax effect.

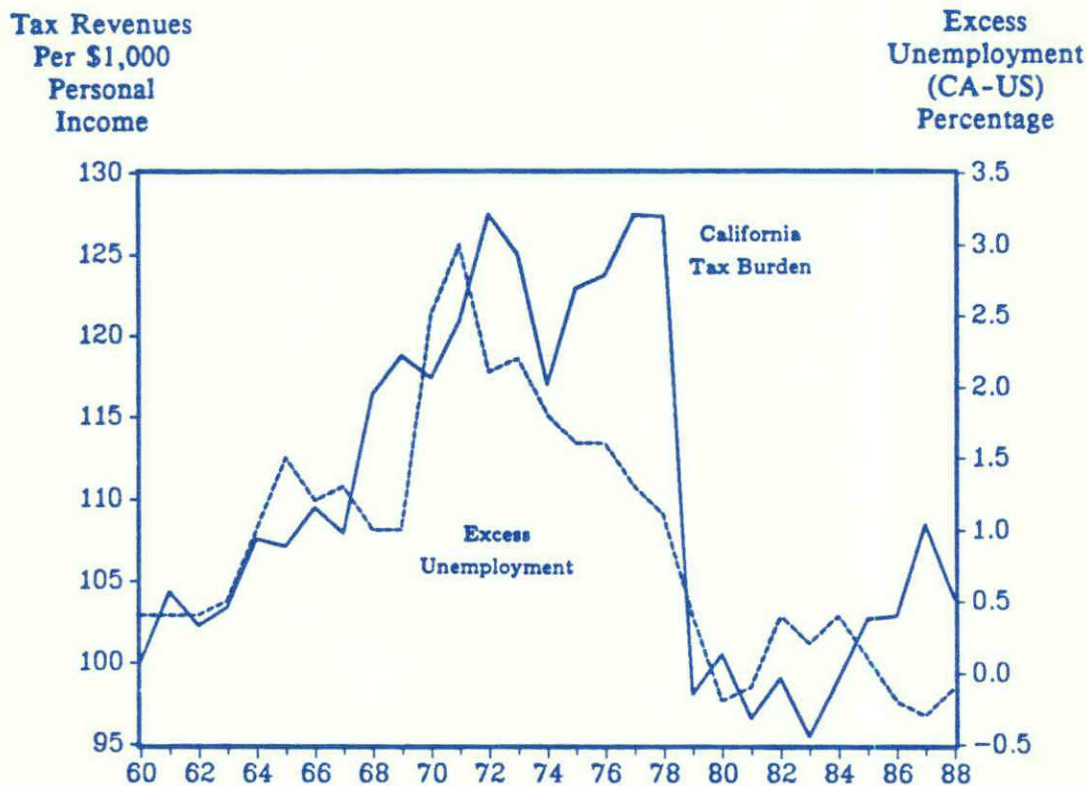
In the very early 1960s California's relative tax burden was quite high but its absolute tax burden was much less than it was in the mid-1970s. As a result of a lower absolute tax burden, California's relative tax burden should have weighed less heavily on California's economy in the early 1960s than in the mid-1970s.

In 1978 a force that had been building strength for several years finally brought a huge and dramatic change to the California economy. In June 1978 Proposition 13 rolled the entrenched political establishment. Proposition 13 was a Constitutional Amendment that i) set property taxes not to exceed 1 percent of the property's value, ii) allowed the base value to grow no more than 2 percent per year unless the property changed hands and iii) required that all new or increased taxes be voted in by a super-majority of the electorate. Proposition 13 won in a landslide.

Following on Proposition 13's heels was an elimination of the state's inheritance tax, an indexing of the state's income tax and an elimination of the state's business inventory tax. In 1979 Proposition 4 passed locking the tax gains into place by requiring a) spending to grow no faster than the sum of population growth and inflation and b) all surplus revenues to be returned to the taxpayers.

Figure 6 shows just how dramatic Proposition 13 *et al* has been to California's relative tax burden. It was amazing! But two points do need to be emphasized. First, while Proposition 13 *et al* did occur in and around 1978 a lot of political build-up had been apparent in California well before 1978.

Figure 7
California Tax Burden vs. Excess Unemployment (Ca-U.S.)



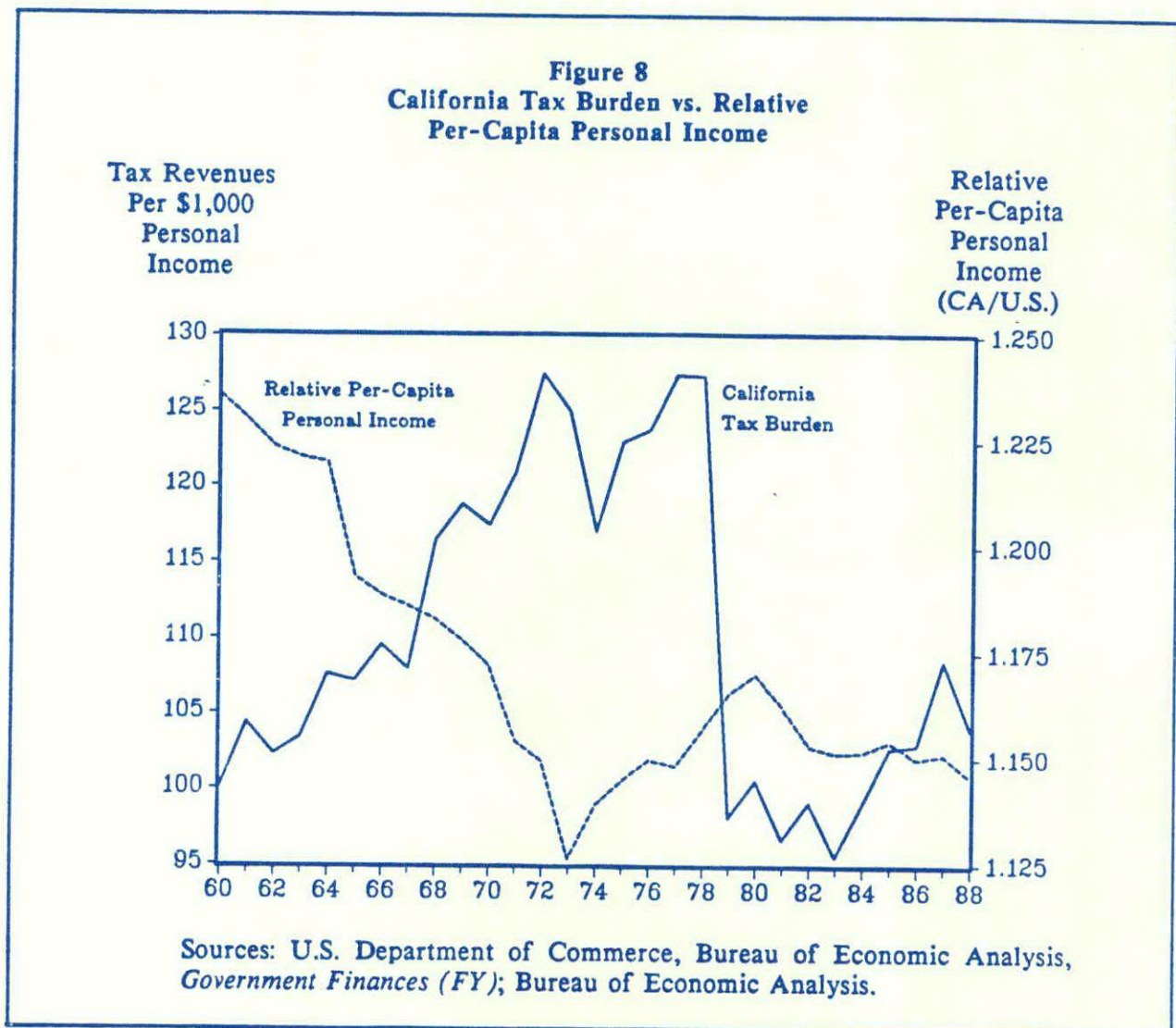
Source: U.S. Department of Commerce, Bureau of the Census, *Government Finances (FY)*; U.S. Department of Labor Statistics.

Second, while Proposition 13 was global in its impact other states had similar measures, a few of which even preceded the passage of Proposition 13.

But knowing that antecedents to Proposition 13 existed in California and that other states had similar measures does not negate the "taxquake from California." Without Proposition 13 there would not have been the Reagan tax revolt and Margaret Thatcher surely would not have been the Margaret Thatcher we know and love.

In the above Figure 7 and the following Figure 8, California's tax burden is directly related to the State of California's economic well-being. In Figure 7, California's tax burden is plotted against California's excess unemployment over the period 1960 through 1988.

As charts of this genre go, this is a good fit. Over the broad sweep of time California's excess unemployment is definitely correlated with California's tax burden. When one realizes just how little is included in this analysis the relationship is much more impressive.



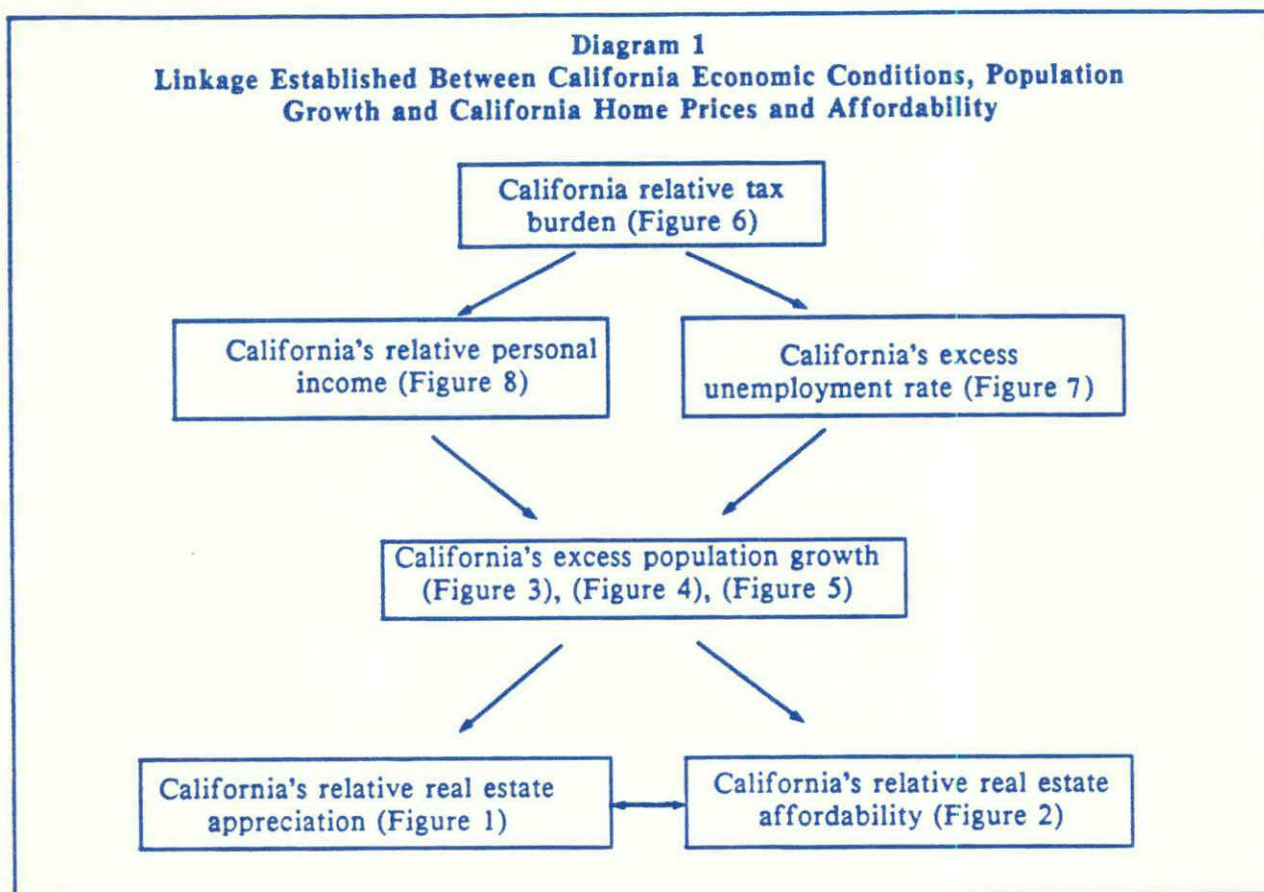
Throughout all the build-up of the Vietnam war, California's unemployment rate was rising relative to the rest of the nation. Now how's that for a surprise? During the Vietnam and defense wind-down California's excess unemployment rate was falling. Even the large defense build-up of the 1980s is scarcely visible in California's excess unemployment rate. On this scale of analysis it's hard to uncover the California effect of the defense budget.

Figure 8 is not meant as new evidence independent of Figure 7. In fact, Figure 8 is a different perspective on the relationship between California's tax policies and the performance of the California economy. Figure 8 is a plot of California's relative per capita personal income against the same tax burden series.

Combining Figures 7 and 8 closes the logical structure. The diagram below illustrates the logical sequence and the relevant figures.

Whither The Value of California Real Estate?

As I am writing this paper, the 485 acre parcel of land immediately to the east of my property is



undergoing a massive transition. The Japanese acquired the property from the bankrupt Southmark Corporation and have started to develop the property in earnest. Close to 800 homes are anticipated over the next five or so years and right now five huge "Cats" and many more giant trucks are building the infrastructure on a 6 day week basis.

Immediately to the west of my property, a 50 acre development has just been readied for 22 new homes. The development was started some three years ago and, while all the lots are ready to begin construction, only four houses are in different stages of production. Another neighbor's house has been "on the market" for about 9 months. In my neighborhood, at least, the pipeline is pretty full.

The early Keynesians liked to think of business cycles in a rather mechanistic fashion. A key element of their theory of the business cycle was the concept called "the accelerator." "The accelerator" was simply the relationship between changes in demand and changes in some specific investment category. For inventories -- an investment of short durability -- "the accelerator" was small. But, when investment capital was long-lived "the accelerator" could be huge.

To illustrate this concept, imagine a static population of some 1000 people where 10 people live in each house. If houses depreciate at 1 percent per year then the construction industry will have to produce one house per year to offset depreciation. Now if population were to grow at 1 percent per year then the construction industry would have to produce two houses per year, one to offset depreciation and one for the additional ten people.

In this example a 1 percent increase in population has led to a 100 percent increase in the size of

the construction industry. Because construction is both on the demand and supply side of the equation the accelerator may be magnified even more. Construction personnel not only build homes but live in them as well.

California's relative housing prices from their low around 1974 have risen an incredible amount. At first, and for quite some time thereafter, California's construction industry just couldn't catch up. Construction was incessantly behind the power curve. The stories are now legend of lotteries in Orange County giving people the right to make offers on houses the ground for which had just been broken. Gadzooks, those were the days. "The Keynesian Accelerator" was alive and well and big.

Even today construction is a huge component of the California economy. But it would be hard to argue that the construction industry is in arrears like it was at the end of the 1970s. If anything, California's construction industry has caught up with the pent up demand and may even be a little ahead.

In June of 1990 California voters passed Proposition 111 which raised the gas tax and the truck weight tax. Proposition 111 also weakened the Gann spending limits passed in 1979. Over the past several years numerous ways have been found to circumvent Proposition 13. By all accounts a new era is at hand.

This new era is far from a complete return to the pre-Proposition 13 era. Senator Pete Wilson defeated Diane Feinstein for Governor which is clearly a plus. Some of the most anti-business initiatives were badly defeated by the California voters in November as well.

From the standpoint of California politics the outlook is far better today than it was at the end of June 1990. Being far better, however, is a far cry from being good.

With the state of California politics and the nation as a whole the conditions just aren't there to justify California's ever-increasing home values. The long and short of it is that California is in for a serious housing slump.

FOOTNOTE

1. In fact, a little digression appears apropos. Ronald Reagan was elected Governor of California in 1966 by a plurality of almost one million votes over incumbent Governor Edmund G. "Pat" Brown, Sr. Reagan was re-elected in 1970 by a 500,000 vote margin over assembly speaker Jesse Unruh.

When Reagan took office the highest marginal personal income tax rate in California was 7 percent. When he left office the highest marginal personal income tax rate was 11 percent. The year in which Reagan took office (1967) taxes as a share of personal income were 10.8 percent. The year in which he left office (1975) taxes as a share of personal income were 12.3 percent.

Reagan also spearheaded efforts to void the state's anti-abortion statutes, successfully led the battle for a state Equal Rights Amendment, and instituted the first criminal furlough program. How's that for egg-in-your-beer?

A.B. Laffer, V.A. Canto & Associates

Political Economy

CALIFORNIA DREAMING

By Arthur B. Laffer

California is in for an unpleasant surprise of considerable magnitude. The tax increase contemplated by Sacramento will, over the next several years, do enormous damage to the Golden State's economy. Property values and employment amongst California's most vulnerable people will be the hardest hit. But everyone will suffer.

And, as for the prize at the end of the rainbow -- that elusive state of fiscal solvency? Unfortunately, the pot's not destined to be brimming over with coins of gold. The fiscal condition of California will not improve in spite of all the pain and suffering. Almost two centuries ago Sir Robert Peale warned politicians that they would be thwarted in their expectations of higher revenues from increased taxation. There is a "Curve" that illustrates exactly this relationship.

As if designed to torment, the prospects of a tax increase will cause California's economy to look as if it were improving only to show its true colors at a later date. But that's only to be expected given the way Sacramento and the rest of the state's local governments operate. They propose, then they talk about, and later they pass legislation, much of which won't take effect until even some later date.

If a tax increase is expected in the near future, people will buy now rather than later to avoid paying the higher taxes. These accelerated purchases will create an illusion of an improved economy. But it is an illusion of the first order. Not only will 1992 be a bad year for California in its own right, but all those purchases made in 1991 in anticipation of higher taxes in 1992 will produce a double whammy for the state in 1992.

The magnitude of California's tax increase is serious by any measure. The projected deficit is over \$14 billion out of projected spending of \$56 billion. An estimate of an \$8 billion tax increase at the state level is conservative. Counties and cities are also raising taxes, in June of last year we had an enormous increase in the state's gas tax, Bush is raising federal taxes and we all are hoping against hope that spending cuts materialize. But spending cuts are far from a sure thing.

Using 1989 as a base, an \$8 billion tax increase would take California from the 22nd highest taxed state in the nation per \$1,000 of personal income to the 9th highest taxed state. A mere \$2.5 billion more in taxes would rank us as the 6th highest taxed state. Someone needs to be congratulated for a job well done.

The \$8 billion proposed California tax increase, if passed, would mean that only two states have had larger percentage tax increases in the past seven years. No one can match us dollar for dollar. One state who outdid us was West Virginia. But, that only happened last fiscal year so we can't really track the results as of yet. The other state was Louisiana in fiscal year 1985. What happened to Louisiana in the ensuing years is etched in stone.

In 1985, the first full year of Louisiana's tax increase, their unemployment rate rose by 1.5

percentage points while U.S. unemployment fell by 4 tenths of one percent. Their state debt was downgraded, as well. In 1986, Louisiana's unemployment rate rose another 1.6 percentage points to 13.1 percent while U.S. unemployment fell 2 tenths of a percentage point to 6.9 percent. The state's debt rating was again downgraded. In 1984, the year before Louisiana's tax increase, their per capita personal income was a little over 83 percent of the national average and by 1987 was down to less than 75 percent of the national average. -- Now there's a role model for California to follow!

But California doesn't need to look for advice from other states, let alone Louisiana and West Virginia. We have a past rich in policy diversity. From the mid 1960s through the mid 1970s California's taxes were way above the national average. In the decade 1967 through 1976 we ranked in the top five highest tax rate states during most of those years. In fact, on a per capita basis, California was the second or third highest taxed state each and every year.

During that same ten year period California's unemployment rate averaged 1.8 percentage points above the nation. Population growth -- while higher than that of the nation as a whole -- was low for California. Housing prices, adjusted for personal income, were below the national average and real income per capita was falling relative to the rest of the nation.

California's boom following the tax cuts of the mid 1970s is legendary. Unemployment fell below the national average, real income per capita grew, population growth accelerated and the real estate market soared. With the tax increases of 1990 and this year's proposed tax increases all of that is at risk. Surely Californians don't want to return to the pre-proposition 13 era irrespective of the wishes of their politicians.

To conceptualize the gross inequities of it all imagine two companies in close competition with each other. One of those companies is located in California while the other is in a neighboring state where taxes are not being raised. Because both companies sell roughly the same products competition requires them to price their products similarly. They pay the same interest rates, supply costs and after-tax wages. California's tax increase, therefore, cannot be passed forward in higher prices or backward on suppliers. The California company has to swallow the tax increase *in toto*.

Clearly rational business decisions would lead to a contraction of the California facilities and an expansion out-of-state. The stock price of the California company will tend to fall and people who can move will move. People who can't move, however, will face the prospects of higher unemployment and lower wages. These people, of course, are those with poor employment skills who are least able to fend for themselves.

Property values will be exceptionally hard hit for there is nothing less mobile in the short term than property -- homes and commercial real estate. In the long run, of course, property can move by constructing new facilities and not replacing old ones as they wear out. This is why California's construction industry will be one of the hardest hit industries. But again, all of this will get into high gear at the beginning of 1992 when the tax increases actually take place.

My estimates for all these effects derived from a combined time series cross-section analysis of the 50 states over the last thirty-five years are as follows:

- o California real estate prices will be down from their previous highs by close to 20 percent by the end of 1994.

- o California's unemployment rate will rise -- relative to the rest of the nation -- by over 2.5 percent from June of 1990 to the end of 1994.
- o California's personal income per capita - again relative to the rest of the nation - will fall by a total of 6 percent by the end of 1994.
- o California's bond ratings will be lowered.
- o California's budget will remain in crisis.

Have a nice day!

June 25, 1991

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Appendix

Here are the \$7.6 billion in new or increased taxes contained in the proposed state budget agreed to by Governor Peter Wilson and the Democratic and Republican leaders of the Senate.

Personal Income Tax

Require businesses to withhold income taxes from independent contractors.	\$530 million
Limit itemized deductions for individuals with incomes higher than \$100,000 and couples making more than \$200,000.	\$272 million
Reduce business meal deduction from 80% to 50%.	\$222 million
Eliminate the renters tax credit for individuals earning more than \$20,000 a year and couples earning more than \$40,000.	\$137 million
Require employers to withhold income taxes on supplemental wages.	\$80 million
Phase out the personal exemption credits for taxpayers with income of more than \$100,000 and joint filers with income higher than \$200,000.	\$43 million
Require estimated tax payments on income from estates.	\$42 million
Cap mortgage interest deduction at \$70,000 for all filers.	\$39 million
Make changes to conform state taxes to federal tax code.	\$17 million
Total personal income tax	\$1.382 billion

Sales Tax

Increase 1/2 cent to pay for state programs	\$1.44 billion
Increase 1/2 cent to pay for local programs	\$1.44 billion
Temporarily increase 1/4 cent for state programs	\$720 million
Extend to candy and snacks, ship and jet fuel, newspapers, magazines, leased equipment, bottled water.	\$462 million
Total sales tax	\$4.062 billion

Telecommunications Tax

6% tax on telephone and cable television bills	\$630 million
Total telecommunications tax	\$630 million

Business Tax

Suspend for two years the right of firms to carry over losses between tax years.	\$560 million
If the reinstatement cost the state more than \$300 million, corporate taxes would be increased to make up the difference.	
Total business tax	\$560 million

Vehicle License Fee

Adopt new depreciation schedule.	
Total vehicle license fee	\$769 million

Alcohol Taxes

Increase taxes on beer, wine and liquor. The tax increase would add about 9 cents to a six-pack of beer and 3/4 cent to a five-ounce glass of wine.	\$210 million
Total alcohol taxes	\$210 million

TOTAL INCREASED TAXES	\$7.613 billion
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Source: *Los Angeles Times*, June 22, 1991, page A22.

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March 20, 1992

This letter is our written response to a request for our view on Arizona and secondly, specifically on a bank investment in Arizona. To be responsive we've also added a little more on California than would strictly be necessary for an investment decision in Arizona as a stand alone. We did this solely because we know that California would be a natural for you, other things being equal. Therefore, we'll divide this letter into four parts. i) The prospects for banking in the U.S. over the next several years. ii) Arizona before Fife Symington's election as governor. iii) Arizona's competitive environment now and in the years ahead e.g., California and iv) The prospects for Arizona with Symington as governor.

i) Banking: In the 1980s President Reagan and Fed Chairman Volcker *et al* dramatically changed what had been the economic environment in America. The economic changes were enormous. Inflation and interest rates tumbled. We don't know if you remember but when we took office in January of 1981 the prime interest rate stood at 21.5 percent. Tax rates were cut drastically both on a statutory basis - federally the highest rate went from 70 percent to 28 percent - and effectively as a result of lower inflation and lower interest rates - illusory gains on capital appreciation, underexpensing of the cost of goods sold and bracket creep (inflation alone pushing people into higher tax brackets). And lastly the economic effects of regulatory reform were fairly sizable as well.

While not strictly economics *per se*, the U.S. defeat of the Soviet Union in the Cold War had major economic consequences as well. The U.S. victory essentially established us as the world's sole superpower and conferred on us all the benefits and responsibilities that that role entails.

Putting all of this together, people radically altered their behavior from the 1970s to the 1980s. Investors stopped investing in the tax shelters, inflation hedges and the likes of windmills and started looking for after-tax yields on assets. As a consequence asset values skyrocketed, whether those assets were real estate, financial capital or real capital. During the 1980s, over 60 percent of the increase in U.S. wealth came from the appreciation in the value of existing assets and less than 40 percent from the increase in the amount of assets.

From the mid 1960s on, real U.S. wealth had not increased very much until Reagan's and Volcker's policies really took effect in 1983. From 1983 on the increase in wealth was unprecedented. It's hard to imagine a greater contrast in economic policies and results than existed between the pre-Reagan era and the Reagan era.

Because of the change in the appreciation in the real value of existing assets between the two periods, people's savings rates changed as well. Stated simply, people don't save to go bankrupt. People save to augment their wealth not to reduce their wealth. To see this intuitively just ask yourself what would happen to the amount you save out of each paycheck (i.e., the amount of your paycheck less how much you spend) if someone gave you \$5 million tax free no questions asked. Your spending would go up and savings would go down.

Well, during the 1980s people received an enormous windfall in wealth as compared to the pre Reagan era and savings tumbled. This fall in savings, along with the rise in investment due to tax, inflation and regulatory changes brought about big changes in the relative performance of various industries. The traded goods sector of the country got hammered as imports rose and exports declined. But apropos to your discussion, financial intermediaries -- banks, S&Ls, leasing companies, insurance companies and brokerage firms -- also were damaged almost beyond recognition.

Financial intermediaries rely on a large volume of savings flows to be profitable. Thus, the 1980s with their sharp declines in savings rates were devastating financial intermediaries. You are seeing the aftermath of those problems even today.

The rest of the 1990s however, promise much less asset appreciation than occurred during the 1980s. The president, Congress, the Fed and especially state and local governments will assure that the economic climate of the U.S. doesn't improve too much. Real asset values will stay flat and savings rates will rise. With investment rates down U.S. trade will improve dramatically. Thus, financial intermediaries will rebound in the 1990s -- especially banks that do not have corrupted balance sheets -- and so will traded goods industries. U.S. banks that finance business in areas where trade is important should do very well.

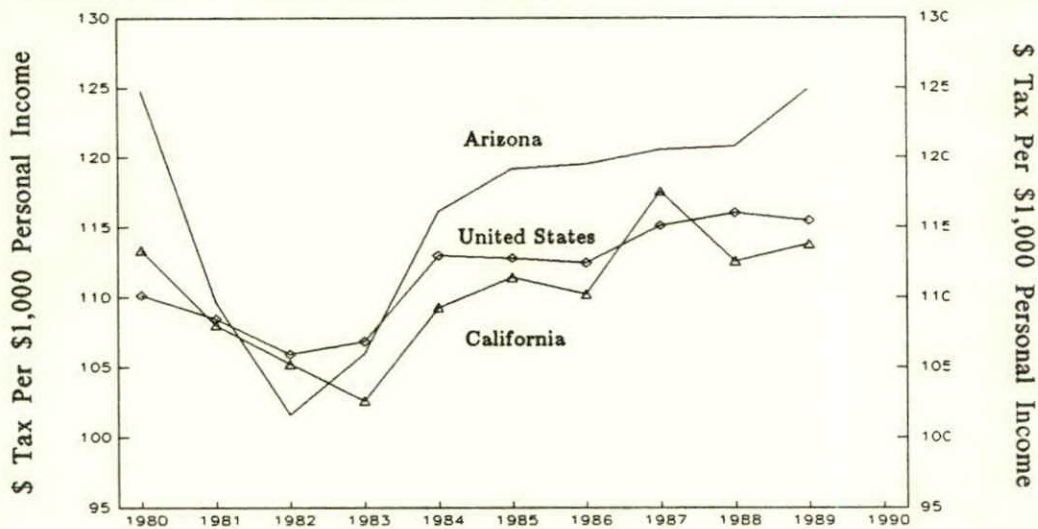
The bottom line to what I'm saying is simply that banks are an extremely attractive industry in which to invest for the rest of this century. This is especially true if the banks have a disproportionately large share of their business with firms involved in traded goods.

ii) Arizona, prior to Fife Symington being elected governor, was the textbook case on how to screw up a state. Governors Babbitt, Mecham, and Mofford were disasters. In tax terms Arizona just raised them and raised them and then raised them again (Table 1, Figure 1). The results were just as you would expect.

Table 1 Arizona Selected Tax Rates					
	Corporate	Individual	General Sales & Use	Gasoline	Cigarette
01 Jan '86	2.5-10.5%	2-8%	5%	.16	.15
01 Oct '87	2.5-10.5%	2-8%	5%	.16	.15
01 Oct '88	2.5-10.5%	2-8%	5%	.16	.15
01 Jul '89	2.5-10.5%	2-8%	5%	.17	.15
15 Jul '90	9.3%	3.8-7%	5%	.17	.15
01 Aug '91	9.3%	3.8-7%	5%	.18	.18

Not only did Arizona bungle its fiscal situation badly but Arizona also became the buffoon of states. The Martin Luther King Day fracas was truly embarrassing. Then came Governor Mecham's impeachment. This was followed by the Keating crisis and the prominence of Arizona's senatorial contingent in the bad press of that time -- they had two senators in the Keating Five. Then came the sting on Arizona's legislature and the wholesale corruption that sting uncovered. Arizona was the worst of all the states and asset values reflected the Arizona environment (Figure 2). You couldn't have gotten more depressed asset values if you had employed Mephistopheles himself.

Figure 1
State and Local Tax Burden
Taxes (Fiscal Year) Per \$1,000 of Personal Income (Previous Calendar Year)

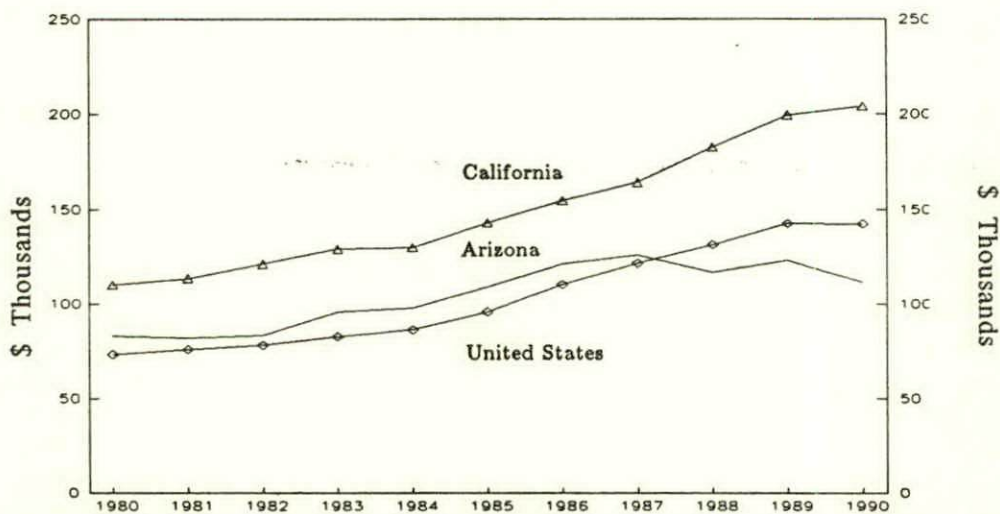


Sources: Federal Housing Finance Board; U.S. Bureau of the Census.

Investments, in our opinion, depend upon how good things are going to be and also on how bad they currently are. Arizona asset values are depressed and that's bullish for investment.

iii) While lots of states affect Arizona's competitive environment one state stands out far ahead of all the others -- California. California is contiguous to Arizona and both states border Mexico. California is also huge in comparison to Arizona. California defines the environment in which Arizona has to operate. Much of what happens in Arizona results from actions taken by California while the reverse is not true.

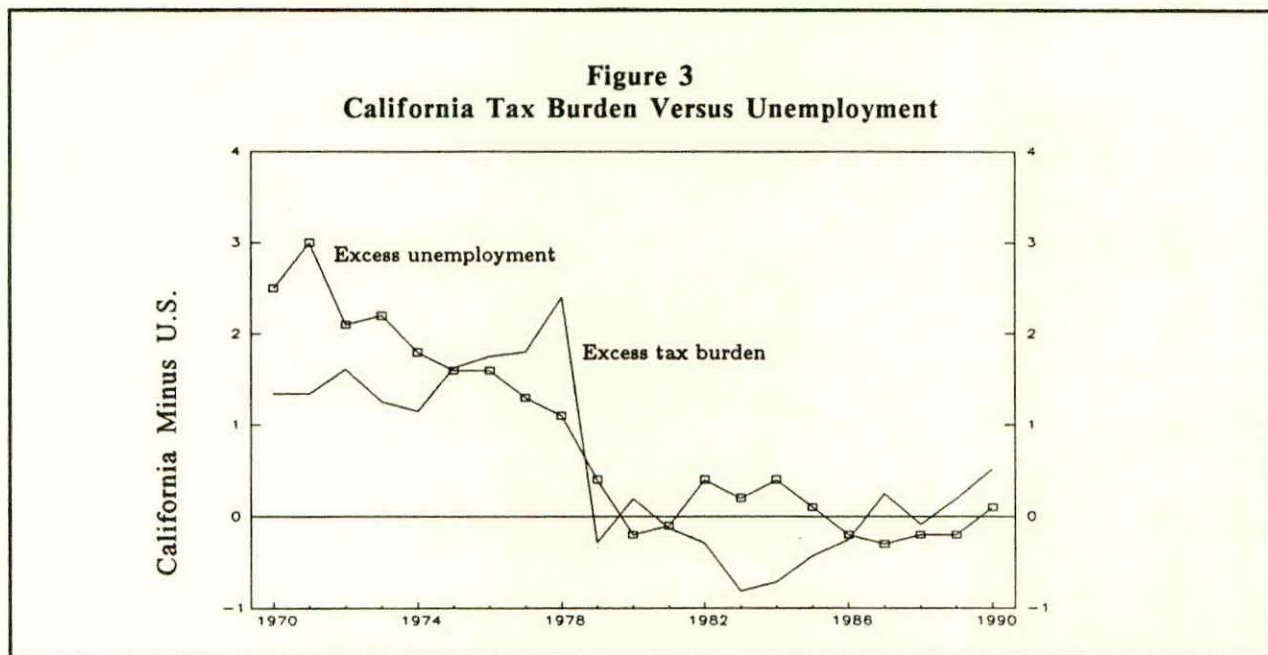
Figure 2
Average Single Family Home Prices



Sources: Federal Housing Finance Board; U.S. Bureau of the Census.

If California does things right, for example, and Arizona does not, Arizona can suffer huge losses just as she did up until recently. If Arizona does things right along with California she'll move right along with California but will have little independent impact on California. If, however, California screws up its economy and Arizona watches her "ps" and "qs" the sky's the limit for Arizona. She'll get more business than you can shake a stick at and in a real hurry. Small losses to California are huge gains to Arizona solely because of the size difference.

Following the passage of Proposition 13 in June of 1978 California went on a roll (Figure 3). Prior to the passage of Proposition 13 California was one of the five top taxed states in the nation year in year out. But after Prop 13 and all the other tax changes (elimination of the state's inheritance tax, business inventory tax, the indexing of income taxes and the GANN spending limits), California remained in the mid 20s for over a decade. California's economy took off.



Unemployment dropped to below the national average, population growth surged and real estate values went off the top of the chart. This was especially true after 1983 when the U.S. economy rose so rapidly as well. California was the best of the best and the evidence was there to prove it.

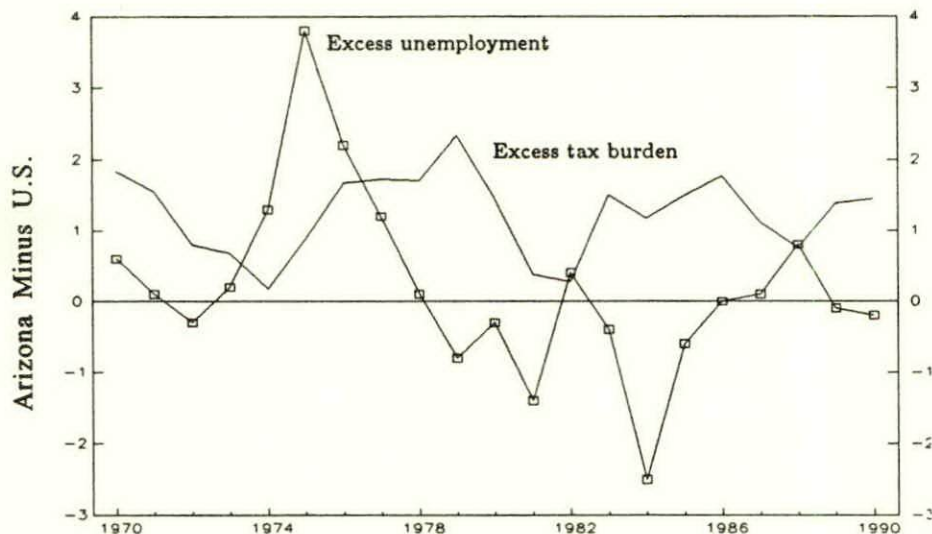
But, with the passage first of Proposition 98 (November 1988) and then Proposition 111 (June 1990) followed on by Pete Wilson's tax increases of heroic proportions, California is headed south in a big big way. We haven't seen anything yet. California has become extraordinarily hostile to growth and business. And that change of economic environment in California should inure to the benefit of Arizona also in a very big way if only Arizona doesn't follow California's lead.

The damage California is doing to herself will be an enormously big plus for Arizona. In our view there is little chance that California will reverse her self-flagellating policies in the near term. State cycles last about a decade on both the upswings and downswings and are surprisingly regular.

Again the meaning of all this discussion about California is simply that California looks bad for investments and Arizona looks all that much better as a consequence.

iv) All we can tell you about Symington as governor is that he's made of all the right stuff. He inherited money, married money and has both made and lost money. He really understands the subject in a very personal way.

Figure 4
Arizona Tax Burden Versus Unemployment



Fife is not a professional politician. Like Reagan, his run for the governor's office was his first attempt at elective office. As a result he is not ingrained with process but looks far more to substance. Fife, by the way, is also a close personal friend and was a client of Laffer/Canto & Associates for years and years.

Fife's uncle was Senator Stuart Symington and his family and personal background attest to a close familiarity with politics even though he'd never literally run for office before. I met Fife at a political "do" in Phoenix years ago -- the Trunk and Tusk (a Republican club) -- and he was pretty high up in the organization. He's clearly not a neophyte. He's also a super Wasp, well plugged in socially all around the country and a Harvard graduate who actually served his country in the Navy. He shares a lot of characteristics, for example, with JFK, Bush, etc. This man has the trappings of greatness. He knows who he is and doesn't need others to tell him if he's doing a good job. He's very well adjusted like Reagan. The man is an all-around winner.

I had lunch with Fife shortly after he was elected governor (May of 1991) and his mindset at that time was to "hold the line," "learn the ropes," and "keep his gunpowder dry." He did just that. He did not succumb to the siren call of a tax increase and took a hell of a lot of heat for it. Since that lunch I've been in frequent contact with him.

He recently proposed a \$65 million tax cut which is big in Arizona terms. This isn't the last cut he's going to propose. There is a substantial body of historical precedence with across-the-board income tax rate cuts that Arizona can rely on to carry out its policies. Whether the focus is on state or federal examples, income tax rate policies have a rich political history.

On a state level the results are also clear to the statistician. There is one concern with state experiences. There are so many individual state episodes as to make anecdotal evidence dangerous. Counter examples can always be found. Nonetheless, the tax cut examples of California in 1978, Massachusetts in 1979, Puerto Rico in 1978, Delaware in 1979, etc. and the tax increase examples of New York, New Jersey, Pennsylvania, Connecticut and California are pretty persuasive.

By way of example, one dollar's worth of business income subject to the top corporate and personal income tax rates at the state and federal level will, after adjusting for sales tax, result in net income of only 37 cents under current law in Arizona. A similar calculation for neighboring states shows Arizona to be the second highest taxed state of the group compared. Washington state has a net after tax income of 43 cents per dollar of pre-tax corporate income: a 16 percent competitive advantage over Arizona. Other states with competitive advantages over Arizona include Nevada 16 percent, Utah 8 percent, Colorado 8 percent, New Mexico 0.2 percent and Oregon 8 percent. The only neighbor over which Arizona enjoys an advantage is California at 5 percent.

A comparison of taxes on wage income yields a similar story. One dollar of wage income subject to the top marginal tax rates will, after adjusting for sales tax, result in 61 cents of net income in Arizona. The same calculation yields 65 cents of net income in Washington, a competitive advantage of 7 percent over Arizona. By this measure Arizona has an advantage over California of 5 percent and New Mexico of 1.6 percent but other neighbors have an advantage over Arizona: Nevada 7 percent, Utah 3 percent, Colorado 5 percent and Oregon 7 percent.

Even more to the point are the data that relate state tax policies to the stock market performance of a portfolio of small companies within that state. In general, the stock prices of companies in states where taxes are falling do well and the stock prices of companies in states where taxes are rising do poorly (Table 2). Already Valley National Bank stock (the only sizeable exclusively Arizona bank) has jumped from a low of \$8½ in 1990 to its current level of about \$33 and Arizona's economy is starting to move.

Table 2
Excess Returns on a Portfolio of Equities Located in States With
Falling Relative Tax Burdens Over An Equivalent Portfolio of
Equities Located in States With Rising Tax Burdens

	1985	1986	1987	1988	1989	1990	1991
Excess Return	16.77%	7.18%	4.48%	7.88%	14.56%	20.24%	10.70%

As an additional observation there is a clear relationship between a state's tax policies and the official ratings on the quality of debt issued by that state. Bond ratings are frequently lowered after a state raises taxes and infrequently lowered after a state lowers taxes. Here is one man with one goal and one vision, one world-wide mission. Fasten your seat belts the best is yet to come.

To summarize our view: i.) banking is one of a select few industries to invest in during the rest of the 1990s, and ii.) Arizona's asset values are exceedingly depressed. Arizona's prospects are exceptionally good because iii.) California is pushing businesses out and iv.) Arizona is becoming far more pro-business.

Sincerely,

Arthur B. Laffer

Victor A. Canto

Arizona State Tax Actions

1978	Passed spending or revenue limitation
1980	Defeated Proposition 13-type initiative.
1982	Raised motor fuel tax from 8¢ to 10¢ per gallon. Substituted severance tax for excise and sales taxes for mining companies. Provided one-time windfall by shifting collection into earlier reporting period. Budget program increase to increase corrections budget. Expanded personal income tax indexing.
1983	Increased sales tax. Increased miscellaneous tax
1984	Made permanent a temporary increase in sales and use tax from 4% to 5%, effective July 1, 1984. Reduced certain credits on individual income taxes. Rate determined by formula. Terminates 1/1/88. Increased cigarette tax from 13¢/pack to 15¢/pack. Property tax decreased from 75¢/\$100 to 40¢/\$100, applicable to tax year 1984 only. Reduced certain personal income tax credits. Rate determined by formula.
1985	Increased gasoline tax 3¢/gallon. Contingent cigarette tax increase.
1986	No major tax changes.
1987	Avoided "windfall" by providing special deduction. Deduction of 46% of federal income tax payment or \$475, whichever is greater. Reduced budget after adoption in response to revenue shortfall.
1988	Increased property tax by increasing tax rate, limited rebate for homeowners and other changes in property tax.. Increased personal income tax by placing \$20,000 limit on deduction for federal tax payments while increasing minimum deduction from \$475 to \$600 and eliminating gas tax deduction. Increased corporation income tax by eliminating special treatment of capital gains and eliminating deduction for dividends of corporations controlled by other corporations. Increased motor fuel tax 1¢ from 16¢ to 17¢.. Increased sales tax on real property rentals, eliminated exemptions for casual property rentals and semiconductor inputs and reduced vendor allowance for collecting the tax.. Increased hotel-motel tax from 4% to 5.5%. Increased insurance premium tax.
1989	Extended personal income tax credit to offset portion of windfall resulting from federal tax reform. Repealed deductions for consumer interest, federal excise taxes and state pensions. Increased state property tax for schools. Imposed sales tax on mail order sales.
1990	\$400 million budget deficit for FY 1991 (General Fund), funding for the Chronically Mentally Ill under threat of court order and State Employee Pay which is lagging comparable pay in private sector. Increased personal income tax and eliminated federal income tax deductibility. Conformed to IRS code for personal income tax. Limited renter's credit.. Reduced rate of sales and use tax from 5.0 to 4.75% on rentals (rate is scheduled to reduce to 4.5% in CY92). Reduced share of state collections of sales and use tax collections to provide

county property tax relief.

Accelerated collections of sales and use tax by requiring advance payments of estimated or actual liability for first 15 days of sales at the time payment is made on the remaining liability for the prior month.

Increased corporation income tax.

Conformed to IRS code for corporation income tax. Abolished old rates and established 9.3% flat tax, eliminating federal income tax subtractions.

Changed definition of certain foreign corporations.

Allowed deduction for controlled corporation dividends for out-of-state corporations.

Eliminated foreign income tax credit.

Eliminated vendor compensation for collecting sales tax.

Reduced sales tax rate on rentals of real property.

Reduced state share of sales tax collection.

Increased motor fuel tax.

Reduced vehicle license tax for certain vehicles from \$30 to \$23/vehicle minimum (3-year phase-down to \$10).

Increased motor fuel tax from 17¢ to 18¢/gallon.

Increased cigarette tax from 14¢ to 18¢/pack.

Increased the minimum school tax rate.

Increased personal income tax withholding.

Increased state percentage of federal income tax withholding rates.

Accelerated sales tax collections.

Accelerated personal income tax collections by requiring estimated quarterly payments.

Accelerated insurance premium tax collections.

Retained in general fund interest earnings generated by other state funds.

Increased minimum school tax rate.

1991

Eliminated the income subtraction for various contributions to pension funds (mainly public service funds) on personal income tax.

Conformed to federal code.

On corporation income tax changed three-factor formula by putting double weight on sales factor.

Enacted exemption of sales and use tax for medical equipment.

On waste and environmental taxes and fees changed from environmental surtax to annual license fee.

Changed basis of jet fuel tax from sales tax to jet fuel tax (now taxed at 3.05¢/gallon).

Reduced assessment ratio for Class 6 property (mainly rental property) from 12% to 11% for CY1993 and 10% for CY1994.

A.B. Laffer, V.A. Canto & Associates

Economic Study

THE NEW MAMBO KINGS

By Victor A. Canto assisted by Francoise Barton and Kristen Holmquist

Two decades ago the prevalent view was that Latin America faced a trade-off between political and economic freedoms. A careful analysis of the data dispels the existence of a trade-off. Countries that had military regimes during the 1970s, on average, experienced slower real GDP growth and higher inflation than countries with democratic regimes.

The conservative democracies delivered political freedom, lower inflation and higher growth than the average military dictatorship. The international socialist/social democratic governments delivered political freedom and reduced economic opportunities. The democracies that adopted market-oriented policies, on average, performed better than the authoritarian regimes and the international socialist governments. The choice became fairly obvious, economic and civil liberties could be delivered as promised by the conservative democratic governments.

The United States is in a position to contribute to the achievement of a political and economic balance in Latin America. Opening U.S. markets to the Latin American countries would be of far more importance than increased aid. The free trade agreement will force the Latin economies to focus on their relative competitiveness. Once competition sets in the role of incentives becomes central to the economic program. Marginal tax rates and property rights of the public in general become key elements to the re-alteration of Latin economies. For the foreign investor an additional element is the rights of minority shareholders.

Once the process is on the way, the movement toward democracy and free market policies in Latin America will continue as long as improvement of economic well-being is noticeable. Only then will these governments remain popular.

Chile and Mexico are clear examples. The economic liberalization process has produced significant economic growth. Both countries appear to be well on their way to achieving economic and political freedoms.

A higher risk strategy would select Argentina and Brazil. Argentina has embarked on a restructuring program and Brazil is following suit. Since the restructuring their stock markets have recovered somewhat. Other countries with potential are Nicaragua and Jamaica. However, these are small open economies and the best way to take advantage may be through direct investment. The wildest of all cards will be played in Cuba where political and economic changes will be forthcoming in the next two years. Countries where drugs are large sectors of the economy are hard to predict. In spite of the violence, Colombia seems to have managed the interaction between the drug and the above ground economy the best.

Venezuela, Panama and Dominican Republic have proven to be great disappointments. The slow growth will ultimately result in a crisis. Our hope is that these countries will avoid a coup or any move away from democracy and will choose liberalization instead. The success of Chile and Mexico should be encouraging examples.

May 29, 1992

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THE NEW MAMBO KINGS

Two decades ago the prevalent view was that Latin America faced a trade-off between political and economic freedoms. There was a presumption that Latin American countries had to choose between one or the other. Looking at the various Latin American governments during the 1980s one must conclude that the Latin countries chose economic well-being over political freedom. At the end of the 1970s, fourteen Latin American countries were under military rule -- Argentina, Bolivia, Brazil, Chile, Cuba, El Salvador, Guatemala, Haiti, Honduras, Nicaragua, Panama, Paraguay, Peru, and Uruguay -- while only six countries, if one counts Mexico's single party rule, were enjoying a democratic process. These countries were Colombia, Costa Rica, Dominican Republic, Jamaica, Mexico, and Venezuela.

The performance during the 1970s of the economies with democracies and authoritarian governments is quite interesting. Authoritarian government expenditures as a percent of GNP declined to 13.41 percent in 1980 from 13.67 percent in 1970. The countries with democracies experienced a rise in spending as a percent of GNP to 13.70 percent in 1980 from 11.36 percent in 1970. The government spending figures point to a lower level of government intervention in the countries with authoritarian regimes, a fact that lends support to the hypothesis of a trade-off between political and economic freedom.¹

The Failure of Authoritarian Regimes in Latin America: The 1970s

A careful analysis of the data dispels the existence of a trade-off. Countries that had military regimes during the 1970s, on average, experienced slower real GDP growth and higher inflation than countries with democratic regimes. During the 1970s, the democratic countries experienced an average annual rise in real GDP of 5.13 percent vs. 4.45 percent for the countries under military rule. Increases in the domestic CPI were also lower for the democracies (13.19 percent vs. 33.04 percent).² In addition to dispelling the notion of a political vs. economic trade-off the data also contradict the existence of an inflation vs. output trade-off (i.e., a Phillips curve).

Regimes with repressive political systems did not deliver the promises of a higher standard of living. The experience shows that Latin democracies, in addition to greater civil liberties, have less government intrusion in their economy than military/authoritarian regimes. The Latin countries realized that the choice was not whether to choose economic or political liberty. The democratic experiences during the 1970s pointed to somewhat better economic conditions and greater political freedom. The choice was clear: Replace the military with a democratic government.

U.S. policy toward Latin America, largely at the insistence of President Carter, focused on human rights. The U.S. pressure further stimulated political changes and gave impetus to the nascent democratic changes in Latin America. Gradually, one by one, the military rulers were replaced by democratic rulers. In contrast to the 1970s, when only 6 of 19 countries were under democratic rule, by the end of the 1980s 17 out of 19 countries were under democratic rule. The sole exceptions were Cuba and Paraguay.³

Democracy and Economic Liberties: The 1980s

The switch in the 1980s to a democratic process swept into office governments aligned with the international socialists. The repudiation of the military governments was such that the political freedom promised by the social democrats overwhelmed the economic programs of the competing ideologies in spite of the economic failure of the redistributionist Frei and Allende administrations in Chile during the early 1970s. The international socialists advocated and implemented redistribution policies and a great degree of governmental intrusion in the economy.

The economic policies espoused by the social democrats included the nationalization of foreign oil companies in the mid-1970s in Venezuela under the presidency of Carlos Andres Perez. Although

less extreme in the nationalization process, the government of Michael Manley in Jamaica also pursued an aggressive redistributionist strategy. Many other Latin American countries adopted similar economic policies as well as an aggressive social agenda. The economic policies focused on income redistribution, an active interventionist government, and a curtailment of individual property rights. A common argument at the time was that any loss in efficiency would be more than made up by a more even distribution of income.

The competing new free market policies were timidly advocated by democratic governments. The accumulation of the experiences of the economic philosophies of the social democrats (i.e., redistributionist) and Christian democrats (i.e., market-oriented) allows the Latin countries to make a choice between the two economic philosophies.

The contrast in economic performance between governments aligned with the different philosophies is quite revealing. In the 1980s the Latin American countries followed a pattern similar to the 1970s. The average GDP growth for these countries was 1.21 percent for conservative democrats versus 0.81 percent for social democrats and 0.61 percent for military governments. The conservative democrats fared even better in comparison to the others in controlling inflation. The average inflation rate for these countries was 25.7 percent over the 1981-90 period. The social democrats and military governments posted 440.2 percent and 430.5 percent inflation rates respectively.

The Rise of Democracy and Economic Liberalism

The conservative democracies delivered political freedom, lower inflation and higher growth than the average military dictatorship. The international socialist/social democratic governments delivered political freedom and reduced economic opportunities. However, what the advocates of the policies associated with social democracies did not take into account was that the inefficiencies would lead to an ever shrinking pie that would make the country as a whole worse off. In fact, when the inefficiencies became large enough, individuals became disenchanted with the political/economic system and the stage was set for the second major wave of changes in Latin America. The democracies that adopted market-oriented policies, on average, performed better than the authoritarian regimes and the international socialist governments. The choice became fairly obvious, economic and civil liberties could be delivered as promised by the conservative democratic governments.

The watershed event that marked the turning tide against the redistributionist model came during the 1980s. The election in 1980 of Edward Seaga as Prime Minister of Jamaica was a repudiation of previous economic policies. Under former Prime Minister Michael Manley, the government had pursued massive redistributive policies. Government consumption as a percent of GNP increased to 23.2 percent in 1980 from 13.9 percent in 1972. The Jamaican inflation rate was in double digits in all but one of the years of the Manley Administration. The growth rate of real output was negative in every year except 1974. During this time direct foreign investment in Jamaica declined, becoming negative during the 1975-79 period. The economic performance of other countries with governments aligned with the international socialists rivaled the Jamaican experience. Most notably, Venezuela, a country with enormous national resources, suffered a significant increase in its inflation rate and an abysmal growth in real GNP.

In Jamaica, the political changes took place within a constitutional democratic framework. In contrast, a decade earlier the Chilean experiences with the redistributionist model came to an abrupt end when the democratically-elected Allende government was overthrown by the military.

The comparison of the two incidents points to the rise of democracy in Latin America during the late 1970s and 1980s. Much of the credit for the institutionalization of the democratic system goes to the social democrats. First, by successfully carrying out the transition from military rule to a democratic rule and second by transferring power to a new government peacefully when the incumbent governments were defeated at the polls.

The disincentives of the redistributionist programs resulted in abysmal growth in Latin America. The ambitious social programs resulted in a rise in public expenditures, financed, in large part, by foreign debt, domestic taxes and money creation. Economic activity declined. Inflation rose, and the debt increased. The outcome was the so-called "lost decade," in which Latin America did not participate in the economic gains realized by western countries.

The failure of the traditional view combined with the changes brought about by President Reagan's economic policies generated an economic response in the rest of the world. The economic effects of Reaganomics were even more noticeable in Latin America because of the similarities of Reaganomics and Chile's economic policies. There was a push for lower tax rates. Table 1 documents the changes in tax structures.

Table 1
Latin American Incentive Structures

	Retention Rate 1985	Retention Rate 1991	Incentive Increase 85-91
Argentina	29.3	37.3	27.3
Belize	50.0	55.0	10.0
Bolivia	58.6	75.3	28.6
Brazil	24.0	45.0	87.5
Chile	36.1	41.0	13.6
Colombia	44.9	61.6	37.3
Costa Rica	41.4	70.4	70.0
Dominican Rep.	25.0	25.0	0.0
Ecuador	44.1	61.2	38.9
El Salvador	40.0	50.0	25.0
Guatemala	41.5	52.7	26.9
Guyana	NA	50.0	NA
Honduras	60.0	54.0	-10.0
Jamaica	41.7	65.3	56.9
Mexico	37.5	54.2	44.4
Panama	38.2	38.2	0.0
Paraguay	52.2	52.2	0.0
Peru	40.4	50.9	26.0
Uruguay	78.0	78.0	0.0
Venezuela	54.4	54.4	0.0

Source: *Individual Taxes, A Worldwide Summary*, Price Waterhouse, 1991.

The retention rate is based on domestic tax structure. Since trade restrictions are not incorporated, care must be taken in making inter-country comparisons. The degree of openness must be taken into account.

The success of the incentive-oriented economic policies became evident. Many of the old-line politicians who subscribed to the international socialist view of political freedom and redistributionist economic policies quickly converted to free market principles. Michael Manley denounced the old ways and acknowledged the failure of the redistributionist model he previously advocated. His campaign was successful and he defeated conservative, Edward Seaga. Even more extreme is the transformation of Carlos Andres Perez in Venezuela.⁴ The president who carried out the nationalization program is now paving the way for market forces and a free enterprise system.

A New Paradigm

The new paradigm in Latin America is that political and economic freedom go hand in hand. The rise of democratic governments and market-oriented policies has been hailed by many as the triumph of ideology. This interpretation of the events gives an unwarranted sense of permanency to the changes that have taken place.

An alternative interpretation of recent Latin American changes is that the move toward free market economics was due to a wish for self-preservation of the dominant political parties. Take the case of Mexico where the Institutional Revolutionary Party (PRI), the dominant party, during the last presidential election, "won" a closely contested election. The opposition party (PRD) accused the PRI of committing fraud. The close margin of victory, the narrowest in the 20th century, and the early questions regarding the constitutionality of the victory, clearly forced the Salinas Administration to take some risks in order to consolidate the new government. The result was an aggressive liberalization program that has improved Mexico's economic performance as well as the popularity of the PRI. The only remaining question regarding Mexico is that of executive succession. The selection process for presidential candidates is not an open one and has not been spelled out in advance. In other cases, where there is wide discontent with the economic policies, as in Venezuela, there is pressure for change (i.e., the attempted coup). In some instances these actions have met with some degree of popular support.

It is a mistake to interpret the triumph of democracy during the 1980s as evidence of the disappearance of authoritarian forces in Latin America. As economic difficulties are encountered, these politicians are just as likely to turn away from democratic principles. One only needs to mention the recent events in Haiti, Peru and Venezuela. The Haitian coup overthrew the legitimate government of President Jean-Bertrand Aristide. The Peruvian self-coup by Alberto Fujimori was justified on the grounds that, as an independent, he was not able to carry out his economic and political reforms. The failed Venezuelan coup was promoted by a military unhappy with the economic situation in Venezuela. These incidents clearly show that authoritarian forces are alive and well and that the recent advances in Latin America are not necessarily permanent.

The Outlook for the 1990s

The experience of the 1980s is used to determine our assessment of the country's outlook. The starting point in our analysis is to identify the countries with the most repressive economic and political systems throughout the 1980s. This group consists of Haiti, Nicaragua, Panama, and Paraguay.

Three countries had authoritarian regimes. In Paraguay, General Alfredo Stroessner has been replaced. However, there does not appear to be any major rush to economic and political reform.

Haiti remains the poorest nation in the Western Hemisphere. Its deposed president is not a free market advocate. Neither are the generals. The lack of political structure keeps Haiti from being a candidate for faster economic growth (Table 2).

Panama had the most open economy in Latin America. In addition, a democratic regime is now in power. U.S. aid is not forthcoming as expected and major problems remain with the Panamanian economy. However, the tax structure ranks Panama at the bottom of the pile. The room for improvement must come from the increase in economic incentives and a democratic rule.

Nicaragua is the one bright spot in this group. Nicaragua was the country that underwent the most dramatic political and economic transformation and suffered the largest losses. Consequently, as political reforms take hold, Nicaragua would be a candidate for recovery. In reversing the economic policies of the Sandinistas the coalition government will increase overall economic incentives, the degree of openness of the economy, and should reverse Nicaragua's economic decline.

Table 2
Economic and Political Indicators Ranking, 1980-90

	Regime Through 1980s	Per Capita GDP	% Change in Per Capita GDP ¹	Openness ²	Retention Rate	Increase in Incentives
Haiti	Authoritarian	21	6	18	NA	NA
Nicaragua	Authoritarian/ Marxist	20	20	5	NA	NA
Panama	Authoritarian	6	8	1	18	15
Paraguay	Authoritarian	12	12	7	12	17
Argentina	Military to International Socialist	9	22	20	19	8
Bolivia	Military to International Socialist	19	13	16	2	7
Brazil	Military to International Socialist	1	3	22	16	1
Peru	Military to International Socialist	7	2	21	13	10
Colombia	Retained same Democratic System	13	9	17	5	6
Costa Rica	Retained same Democratic System	8	11	6	3	2
Dominican Republic	Retained same Democratic System	16	15	8	20	14
Guatemala	Retained same Democratic System	18	17	15	11	9
Venezuela	Retained same Democratic System	3	19	10	8	18
El Salvador	From Military To Democracy	15	5	14	15	11
Honduras	From Military To Democracy	14	1	12	10	19
Uruguay	From Military To Democracy	2	16	13	1	16
Ecuador	From Military To Democracy	17	18	11	6	5
Jamaica	Retained Political system, adopted pro-growth policies	11	7	4	4	3
Chile	Adopted pro- growth policies	5	14	9	17	12
Mexico	Adopted pro- growth policies	4	10	19	9	4

1. Ranked in ascending order (i.e., larger drop ranks first).

2. Volume of trade as percent of GDP.

Source: *International Financial Statistics*, IMF; *Individual Taxes, A Worldwide Summary*, Price Waterhouse, 1991.

Four other countries - Argentina, Bolivia, Brazil, and Peru - moved from a military regime to an international socialist regime with an improvement in their political conditions and a potential for economic improvement. Two of the countries - Peru and Bolivia - are mired in a drug economy that will significantly undermine any non institutional economic reform. The remaining two countries in the group - Brazil and Argentina - are closely matched in their openness to international trade and economic incentives. Both ranked below average. In spite of the economic and political disincentives, both countries ranked above average in GDP per capita, attesting to their economic potential. The recent switch to a democratic system and the announcement of market-oriented policies makes these two countries likely winners. The resolve of these countries to maintain these economic policies remains to be seen.

Five countries - Colombia, Costa Rica, Dominican Republic, Guatemala, and Venezuela - have retained their democratic systems without significantly altering their economic programs. Colombia has been involved in a drug war and a parallel drug economy. These circumstances make Colombia's economy difficult to analyze and predict. The remaining four countries are comprised of fairly open economies, and are thus well poised to take advantage of any free trade initiative.

The Dominican Republic and Venezuela have been involved in redistributionist policies that have hindered economic growth and fostered political corruption. The frustrations have already resulted in one attempted coup in Venezuela. Short of a major shift in economic policy toward market-oriented policies, these countries are doomed to remain stagnant. Costa Rica is the country best positioned to take advantage of peace in Central America.

Improvements in the political system are clearly noticeable in countries that moved from military to democratic systems: El Salvador, Honduras and Uruguay are examples. Democracies that adopted pro-growth policies are Jamaica and Ecuador.

With the exception of Jamaica, these countries rank among the least open economies in Central America. Honduras and El Salvador also rank at the bottom in terms of tax policies. Only Jamaica appears to have opened its economy and increase incentives to retain its earlier success. Within this group, Jamaica is best positioned to take advantage of the 1990s.

Mexico and Chile are interesting case studies. They retained their political systems and, for a variety of reasons, they enacted economic reforms. The changes brought about have resulted in a resurgence in the Mexican and Chilean economies. More importantly, the economic changes have produced significant political changes. Chile has moved to a democratic form of government and in Mexico, the electoral contests have become more competitive.

Identifying the Winners

One important element in identifying the winners in Latin America is the U.S. economic policy toward the region.

The United States is in a position to contribute to the achievement of a political and economic balance in Latin America. On the political front it can create pressure to ensure continued progress in human rights. On the economic front it can cease to promote redistributionist policies destructive to economic growth. Direct assistance used to fund these activities serves only to create economic dependency. Opening U.S. markets to the Latin American countries would be of far more importance than increased aid.

The free trade agreement will force the Latin economies to focus on their relative competitiveness. Once competition sets in the role of incentives becomes central to the economic program. Marginal tax rates and property rights of the public in general become key elements to the re-alteration of Latin economies. For the foreign investor an additional element is the rights of minority shareholders.

In an idealized world where people and capital goods and services are free to move, factor migration and trade will result in an equalization of returns. Hence, the countries' GDP will tend to be equalized. Absent differences in natural resources (i.e., immobile factors), the countries with the lowest per capita income will have the greatest potential. In practice, however, barriers do exist and all factors are not completely mobile. Whether a country achieves its potential GDP depends on its ability to remove trade barriers and improve its mobility. The per capita GDP and the countries' population give a rough indication of the potential market size in Latin America (Table 3). The political system determines

Table 3
Population and per Capita GDP

	1990 Population (millions)	1990 Per Capita GDP (\$U.S.)
Argentina	31.93	1887
Belize	0.20	1836
Bolivia	7.19	776
Brazil	150.37	2971
Chile	13.17	2110
Colombia	32.99	1221
Costa Rica	2.99	1907
Dominican Republic	7.17	1019
Ecuador	10.78	1009
El Salvador	5.25	1142
Guatemala	9.20	821
Guyana	0.80	320
Haiti	6.49	386
Honduras	5.11	1167
Jamaica	2.39	1625
Mexico	84.49	2373
Nicaragua	3.87	427
Panama	2.42	2045
Paraguay	4.28	1230
Peru	22.33	2015
Uruguay	3.09	2660
Venezuela	19.73	2447

Source: *International Financial Statistics*, International Monetary Fund.

the basic framework under which property rights are determined and observed. Economic policy will further enhance or reduce these property rights.

When a country's economic policy shifts to a pro-growth, supply-side agenda, its tax rates will fall relative to other countries and economic activity will increase.⁵ Due to the connection between domestic economic policies (e.g., tax rates) and economic performance, the value of assets located in countries that are altering their policies will fluctuate in predictable directions.

Higher after-tax return will result in a net capital inflow. Given a floating exchange rate the trade balance will mirror the capital account. Ultimately the capital flow will reduce the after-tax return to its long-run equilibrium and the surge in the foreign exchange value of the currency will ultimately be reversed. These symptoms have been observed in the United States during the Reagan revolution as well as in Chile and Mexico during their economic reforms. These indicators, a capital inflow, trade balance deterioration and a deviation from purchasing power parity, can then be used to determine whether the liberalization policies are truly having an impact on the countries' economics. Once the

process is on the way, the movement toward democracy and free market policies in Latin America will continue as long as improvement of economic well-being is noticeable. Only then will these governments remain popular.

Chile and Mexico are clear examples. The economic liberalization process has produced significant economic growth. Both countries appear to be well on their way to achieving economic and political freedoms.

The improved economic conditions have been paralleled by an increase in the secondary market prices of debt to 89 cents on the dollar for Chile and 61.63 for Mexico (Table 4). The numbers suggest there is room for further improvement. The two countries' stock markets reflect a similar performance and

Table 4
Latin American Debt, Secondary Market Prices

	December 1986	December 1987	December 1988	December 1989	December 1990	December 1991
Argentina	64	36	21.5	12.25	20.25	37.38
Bolivia	9	10	11	11.5	NA	NA
Brazil	74	46	39.5	23.5	24.75	31.38
Chile	68.5	53	59	60.5	73.75	89
Colombia	84	63	57	65	69	87.75
Costa Rica	36	15	13	19	30	43
Ecuador	65	34	12.5	15	19.87	22.5
Mexico	56	50	41.5	36	45.75	61.63
Nicaragua	5	5	4	3	NA	NA
Panama	67	35	17	18	12.5	20.5
Peru	21	8	5	6.25	4.25	12.25
Venezuela	73.5	58	38	35.5	50.25	67.63

Source: *LatinFinance*, No. 34, p. 10.

Table 5
**Latin American Stock Price Index Performances and
Recent Market Capitalization**

	1982	1983	1984	1985	1986	1987	1988	1989	1990	1991*	Market Capitalization \$BB-US
Argentina	-61.9	44.6	-19.4	74.5	-26.7	6.7	30.2	136.0	-37.8	535.5	19.2
Brazil	-25.7	31.3	41.0	81.3	-27.0	-65.9	104.2	39.3	-67.6	85.6	58.9
Chile	-57.0	-33.6	-28.1	35.5	134.4	17.8	22.2	35.0	31.5	62	30.3
Colombia				-25.1	120.7	62.4	-18.1	5.9	26.7	191.7	4.4
Mexico	-79.2	84.6	-2.1	7.8	82.4	-11.0	98.5	66.6	25.2	144.4	126.
Venezuela				-29.8	51.6	48.1	-26.5	-35.3	572.0	32.2	11.6

* 1991 performance = 12 months to February 1992

Sources: *Emerging Stock Markets Factbook*, International Finance Corporation, 1990;
Global Finance, April 1992, pp. 50.

they increased in excess of 60 percent last year (Table 5). That is further evidence of the economic and political revolution taking place. With the process under way the rates of appreciation will decline to more reasonable levels. Our best guess is, however, that the experiment will succeed and the gains will be sustained for several years into the future.

A higher risk strategy would select Argentina and Brazil. Their abysmal economic policies have resulted in a deterioration in their debt price. The price has fallen more than 40 percent since 1986. However, there may be a light at the end of the tunnel: Argentina has embarked on a restructuring program and Brazil is following suit. Since the restructuring their stock markets have recovered somewhat. Although it is not clear that the current administrations will succeed, the value of the debt is rebounding. The market appears to be more confident of Argentina's gains. The Argentine stock market and secondary debt appreciation has been greater for Argentina than for Brazil.

Other countries with potential are Nicaragua and Jamaica. However, these are small open economies and the best way to take advantage may be through direct investment. The recovery in Jamaica should be slower and steadier than that of Nicaragua.

The wildest of all cards will be played in Cuba where political and economic changes will be forthcoming in the next two years. Cuba, because of its proximity to the United States, educated population and other attributes, will provide the greatest return.

Countries where drugs are large sectors of the economy are hard to predict. The economic and political prospects depend on the outcome of the war on drugs. In spite of the violence, Colombia seems to have managed the interaction between the drug and the above ground economy the best.

Venezuela, Panama and Dominican Republic have proven to be great disappointments. Short of major economic reform, which we do not foresee, these three countries will continue to linger in mediocrity. The slow growth will ultimately result in a crisis. Our hope is that these countries will avoid a coup or any move away from democracy and will choose liberalization instead. The success of Chile and Mexico should be encouraging examples.

The changing fortunes in the Latin countries will be reflected in relative asset values. The privatization programs provide a list of industries that investors may use to take advantage of coming changes (Table 6).

FOOTNOTES

1. Implicitly this argument assumes that the country is in the normal range of the Laffer tax spending curve. If the economy is in the prohibitive range a higher tax rate (i.e., higher intervention) results in lower revenues and, as a consequence, lower spending.
2. The allocation of countries to the two different groups was based on the number of years the countries were under military or democratic rule. Based on these criteria, Guatemala qualifies as a democratic government even though it had a military government at the end of the decade. Approximately half of Chile's economic performance occurred under a democratic system, therefore Chile was not classified under either group. Mexico was excluded because of its peculiar one-party domination. Cuba was excluded because of lack of data.
3. Recently there has been a coup in Haiti. Time will tell whether the coup will succeed.
4. James Tanner, "Change of Heart: Venezuela Now Woos Oil Firms It Booted In '70s Nationalization," *Wall Street Journal*, October 2, 1991, p. 1, A7.
5. Tax rates are broadly defined here to include any distortions generated by national economic policies.

Table 6
Latin American Privatization Programs and Asset Sales

Country	Asset Sales 1991	Plans to Privatize	Privatization Trends
Argentina	30% Telefonica (\$849M), oil field concession (\$173M), 49% oil trading company Interpetrol.	SEGBA electricity unit. Gas del Estado assets of state oil company YPF and OSN water system.	1992 sales program government expects to raise \$3.5B.
Brazil	75% steel company Usiminas Siderurgicas de Minas (\$1.7B), 90% jet engine company Celma (\$59.4M), manufacturer Mafersa (\$51M) steel company Cosinor (\$14M).	28 companies primarily in the fertilizer, petrochemical and steel sectors (valued over \$7B).	After lowering a number of foreign investment hurdles, the government expects to get better foreign participation in 1992. Privatization of water system being studied.
Chile		Shipping company, part of railroads, concessions for operating water treatment facilities	Chilean President Patricio Aylwin postponed plans to privatize Empresa Nacional del Petroleo, the state oil company
Colombia	70% Colombiana Automotriz(\$52M), Banco de los Trabajadores (\$4.4M), Banco Fequendama (\$40M), Banco Internacional (\$21M).		State oil company, Ecepetrol, not likely to be privatized soon.
Ecuador			IMF and World Bank calling for privatization before they reenter loan talks.
El Salvador		Banco Agrícola Commercial and Banco Cuscatlan, two of the country's largest banks	
Guyana	Telecommunication network for \$16.5M.	Guyana Electricity Corporation	
Jamaica	20% Telecoms of Jamaica (\$42M), nearly all of the state hotels	46 public enterprises ready for divestment, including National Commercial Bank, Air Jamaica and Petrjam.	Privatization may follow the decentralization of National Water Commission; airports studies underway.
Mexico	60% Telemex (\$2.17B), Bancomer (\$2.55B), Multibanco (\$204M), Bapais (\$182M), Banca Cremi (\$284M), Banamex (\$3.2B), Confia (\$293M), Banorient (\$73M), Bancreser (\$140M), Ahmsa (\$145M), 80% Sicartas (\$170M), and Sibalsa (\$25M).	Remaining 9 banks, insurance company Asemex, Channel 7TV company, fertilizer company Fertimex, railroad construction company, Concaril, and fish products company Ocean Garden	1991 sales netted \$9.4B and 1992 sales expected to yield \$8B.
Nicaragua	7 state owned companies	21 enterprises in the process of privatization and four targeted	Debt agreement with World Bank likely to spur privatization.
Panama	Air Panama (\$23M).	Routes of Air Panama up for bid	Partially as a result of \$5.4B external debt, President Guillermo Endara's government is said to be embracing privatization.
Peru	15% Sowegiese Leasing S.A.	Part of Entel, the state-owned telephone company; 70% Airline Aeroperu; and state mining companies	President Alberto Fujimoro faces a strong incentive to privatize with debt payments reaching \$500M a year.
Uruguay		State-owned telephone company (AN-Tel), airline (PLUNA), electricity company (UTE), and fishing companies	Uruguay Congress authorized state-owned companies to take on private partners, but limits stake to 60%.
Venezuela	60% airline Viasa (145M) and 40% Telefonos de Venezuela (\$1.89B), 88\$ Astinave (\$20M).	Cement company, 4 hotels, 7 sugar mills and airline Aeropostal	Privatization of state water company, Hidroven, being studied.

Source: *Privatization 1992*, Reason Foundation, 1992.

A.B. Laffer, V.A. Canto & Associates

Investment Study

THE LAFFER-CANTO CONDITIONAL FORECASTER

By Victor A. Canto and Arthur B. Laffer

The Laffer-Canto conditional forecasting technique, when applied to the industry groups' earnings time series, yields earnings forecasts conditional on the market's interest rate expectations. These forecasts are then used to calculate the probability of the percent change in industry earnings outperforming the S&P 500 forecasts. During the third quarter of 1992 the performance of each of the different portfolios was lower than that of the S&P 500. The portfolio with 50 percent probability increased 1.10 percent versus a 2.37 percent gain for the S&P 500. The equal-weighted average of all the industry groups included in the S&P 500 index increased 1.59 percent. It thus appears that 78 basis points of the performance are attributable to the weighting and not the selection of the industry groups. The performance of the 55 percent portfolio deteriorated 27 basis points over that of the 50 percent portfolio. The 60 percent portfolio outperformed the 55 percent portfolio by 76 basis points.

The year-to-date performance of the recommended portfolios is, as expected, positively related to the threshold probabilities used. That is the year-to-date performance of the 55 percent portfolio is better than that of the 50 percent portfolio. In spite of the third quarter underperformance, the year-to-date performance of the recommended portfolios is better than that of the market indices. The 50 percent portfolio is up 141 basis points on the year, much better than the 17 basis point rise in the S&P 500. However, the superior performance is largely due to the equal weighting of the industry group, whose year-to-date average is up 335 basis points. The year-to-date performance of the 55 and 60 percent portfolio of 4.25 and 7.03 percentage points respectively is well above the S&P 500 and the equal-weighted industry averages. Thus, in spite of the second quarter setback, the strategy continues to outperform the market.

Industry Groups With An Estimated Probability of Outperforming The Market Exceeding 50 Percent for the Fourth Quarter 1992

Commercial Services	Food Wholesalers	Medical Products & Supplies
Financial Miscellaneous	Aerospace	Cosmetics
Housewares	Personal Loans	Toys
Insurance Brokers	Containers-Metal & Glass	Aluminum
Manufacturing-Diversified	Multi Line Insurance	Home Building
Building Materials	Beverages-Alcohol	Publishing
Health Care-Diversified	Hotel/Motel	Retail-Food Chains
Office Equipment & Supplies	Beverages-Soft Drinks	Broadcast Media
Hardware & Tools	Automobiles	Leisure Time
Containers-Paper	Electronics-Instrumentation	Tobacco
Metals Miscellaneous	Truckers	Shoes
Computer Software & Services	Retail-Dept. Stores	Computer Systems
Machinery Diversified	Publishing-News Papers	Oil & Gas Drilling
Paper & Forest Products	Restaurants	Engineering & Construction
Retail-General Merchandise	Pollution Control	Health Care-Drugs
Electronics-Defense	Manufactured Housing	Electronics-Semiconductors
Chemicals	Hospital Management	Oil-Integrated Domestic
Retail-Specialty	Textile Apparel	Life Insurance
Chemicals-Diversified	Auto Parts-After Market	

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THE LAFFER-CANTO CONDITIONAL FORECASTER

The marriage of classical economics with modern finance surely must have been conceived in heaven. The considerable resources of modern finance have extended the frontiers of our knowledge uncommonly far. Recognized experts in the field of finance, as recently as one quarter of a century ago, would be totally lost in the field of their own choice today. The classical economic theory of how markets adjust to external shocks, sometimes called after the French word "tatonnement," is the contribution that fills the void in the field of finance.

Without drifting too far afield, markets are nothing more than conceptual locations where demanders meet suppliers. Prices are the ratios of commodities in the actual act of exchange. When markets clear, demanders have acquired all they want and suppliers have supplied all they want. The clearance of a market is associated with a specific price and quantity and is referred to as equilibrium.

A given shock to a market is a term used to describe a shift in either demanders' or suppliers' preferences. If such a shock occurs the previous equilibrium price and quantity will no longer be apropos of this market. The new equilibrium clearance conditions will be satisfied by price and quantity adjustments. Just how and to what degree a specific market adjusts is key to that industry's profitability. Therefore, how a market adjusts to shocks will determine that industry's future profitability and as a consequence, its equity values.

This approach redresses several of modern finance's more serious shortcomings. It proceeds directly from the theory of the firm and the household to establish the principle as to how any market returns to equilibrium following a macro-economic shock. In principle, equilibrium is restored by some combination of price and quantity adjustment. Whether the alteration in the market operates through the industry's demand schedule or supply schedule, price and quantity will be the rebalancers. Quite clearly, from the standpoint of any specific firm within an industry, the greater the impact of macro-economic shocks and the greater the role played by price in the adjustment process the greater will be the sensitivity of that industry's profits and stock value.

Different shocks could well result in widely different industry responses. Knowledge of the relevant supply and demand elasticities for each and every type of macroeconomic shock on an industry-by-industry basis would be ideal to allow us to gauge the precise impact of any macro-economic event. However, direct measurement of the relevant supply and demand elasticities for even one industry is so arcane a task as to render such an endeavor futile. To imagine the extension to all industries is to imagine the squaring of our ignorance. Far more tractable would be an equivalent approach to measure the impact of various shocks directly on the industries' stock prices.

The Laffer-Canto Conditional Forecaster

While rooted in economic theory, both the conception and the measurement of equity responses to macro-economic events is straightforward. First, the implicit market forecast derived from future interest rates can be used to construct estimates of the interaction of equities with inflation and tax rates. Inflation, along with the current U.S. tax codes, leads to ever-higher tax rates. Whether pushing income earners into higher tax brackets, forcing firms to under report their expenses or creating illusory capital gains, inflation raises taxes. People don't work to pay taxes. Firms do not produce goods as a matter of social conscience. People work, in part, to earn after-tax wages and firms produce goods to earn after-tax profits. High and rising tax rates discourage production by removing incentives. Second, pillaging data from the more recent past allows us to establish links between expected macro-economic events and the returns of equities by industry. In the past, tax policies have changed a number of times, as has the course of inflation, interest rates, exchange rates, and protectionist activities. All

the while immersed in deep silence, markets have reassessed the equity values of the various industry categories.

From all we are able to uncover, the market's reassessment of equity values is far from haphazard. There are distinct patterns that emerge. Some are focused with great resolution while others are only dimly visible through the vast array of numbers.

Our interpretation of the empirical relation is as follows: The strategy compares expected macro-economic events implicit in the expected interest rates with asset relatives. If data patterns observed in the past can be presumed to extend into the future then knowledge of what is to be for the economy can readily be translated into what is to be for stock returns. As a guide for asset managers such linkages may prove quite valuable. Asset managers are one group with the curse always to be fully committed. Whether in or out of the market, their performance is continuously at risk. They have no choice.

The empirical method, when applied to the industry groups' earnings time series, yields earnings forecasts conditional on the market's interest rate expectations. These forecasts are then used to calculate the probability of the percent change in industry earnings outperforming the S&P 500 forecasts.

Under most general valuation models a positive relation is to be expected between earnings and stock prices. Thus the estimates of the earning possibilities may be used to select the industry groups whose stocks are likely to outperform the market. The higher the probability is, the smaller the number of industries that will satisfy the threshold, the less diversified the portfolio.

The 1992 Industry Groups' Performance

Applying the technique to data through the second quarter of 1992, we obtained estimates of the probability that individual industries would outperform the market during the third quarter of 1992. The probabilities are ranked in descending order so that the various portfolios may be easily constructed (Table 1). For example, electronics instrumentation had an estimated probability of 61.12 percent (Table 1, Column 2). All industries ranked above electronics instrumentation also have probabilities in excess of 60 percent. The quarterly performance for electronics instrumentation of -16.25 percent is reported in Table 1, Column 3. The average performance of all industries with an estimated probability of 60 percent or better was 1.59 percent and is reported in Table 1, Column 4.

During the Third Quarter of 1992: the performance of each of the different portfolios was lower than that of the S&P 500 (Table 2). The portfolio with 50 percent probability increased 1.10 percent versus a 2.37 percent gain for the S&P 500. The equal-weighted average of all the industry groups included in the S&P 500 index increased 1.59 percent. It thus appears that 78 basis points of the performance are attributable to the weighting and not the selection of the industry groups.

During the third quarter the portfolio did not show a systematic pattern with threshold probabilities. The performance of the 55 percent portfolio deteriorated 27 basis points over that of the 50 percent portfolio. The 60 percent portfolio outperformed the 55 percent portfolio by 76 basis points.

The Year-to-Date Performance of the recommended portfolios is, as expected, positively related to the threshold probabilities used. That is the year-to-date performance of the 55 percent portfolio is better than that of the 50 percent portfolio.

In spite of the third quarter underperformance, the year-to-date performance of the recommended portfolios is better than that of the market indices (Table 2). The 50 percent portfolio is up 141 basis

Table 1
Performance for Third Quarter 1992

	Probability of Excess Performance	Industry Performance 3rd Quarter	Portfolio Performance 3rd Quarter
Transportation-Miscellaneous	99.90	-14.37	-14.37
Housewares	99.90	6.55	-3.91
Financial Miscellaneous	99.90	3.17	-1.55
Commercial Services	99.14	-2.15	-1.70
Insurance Brokers	94.47	17.22	2.08
Building Materials	89.30	2.84	2.21
Health Care-Diversified	87.11	-1.45	1.69
Hardware & Tools	83.98	-8.21	0.45
Paper & Forest Products	81.71	-4.68	-0.12
Metals Miscellaneous	81.45	-10.90	-1.20
Engineering & Construction	75.80	9.89	-0.19
Containers-Paper	75.80	-9.98	-1.01
Manufacturing-Diversified	75.00	4.39	-0.59
Chemicals	73.60	-3.43	-0.79
Electronics-Defense	72.24	6.49	-0.31
Retail-Specialty	71.70	16.44	0.74
Machinery Diversified	71.37	3.36	0.89
Office Equipment & Supplies	70.04	13.78	1.61
Chemicals-Diversified	69.40	-3.28	1.35
Aerospace	66.62	0.03	1.29
Containers-Metal & Glass	64.98	10.90	1.74
Multi Line Insurance	64.43	11.40	2.18
Hotel/Motel	63.62	10.26	2.53
Beverages-Alcohol	63.39	0.57	2.45
Retail-General Merchandise	63.15	10.64	2.78
Automobiles	62.80	-18.19	1.97
Computer Software & Services	61.59	-5.88	1.68
Manufactured Housing	61.18	15.77	2.18
Personal Loans	61.15	2.75	2.20
Electronics-Instrumentation	61.12	-16.25	1.59
Truckers	59.16	-0.58	1.52
Textile Apparel	57.27	6.89	1.69
Publishing-Newspapers	56.50	1.23	1.67
Aluminum	56.17	-14.19	1.21
Broadcast Media	55.96	-2.00	1.12
Hospital Management	55.14	-9.16	0.83
Publishing	54.10	-5.25	0.67
Home Building	54.08	14.38	1.03
Restaurants	54.07	-2.42	0.94
Communication Equipment Mfrs.	53.31	-7.55	0.73
Oil-Integrated Domestic	52.72	5.05	0.83
Leisure Time	52.28	-11.64	0.53
Electronics-Semiconductors	52.26	16.44	0.90
Retail-Dept. Stores	52.08	0.55	0.90
Auto Parts-After Market	51.45	-3.94	0.79
Cosmetics	50.54	15.04	1.10

Table 2
Laffer-Canto Industry Groups Portfolio Strategy 1992 Performance

Probability Level	First Quarter Portfolio Performance	Second Quarter Portfolio Performance	Third Quarter Portfolio Performance	Fourth Quarter Portfolio Performance	1992 Year-to-Date Performance
50	1.91%	-1.57%	1.10%		1.41%
55	3.90	-0.49	0.83		4.25
60	5.05	0.29	1.59		7.03
All industries	1.71%	0.02%	1.59%		3.35%
S&P 500	-3.21	1.10	2.37		0.17

points on the year, much better than the 17 basis point rise in the S&P 500. However, the superior performance is largely due to the equal weighting of the industry group, whose year-to-date average is up 335 basis points.

The year-to-date performance of the 55 and 60 percent portfolio of 4.25 and 7.03 percentage points respectively is well above the S&P 500 and the equal-weighted industry averages. Thus, in spite of the third quarter setback, the strategy continues to outperform the market.

The 1992 Fourth Quarter Forecast

Applying the technique to data through the third quarter of 1992 we obtained estimates of the probability that individual industries would outperform the market during the fourth quarter of 1992. The probabilities are ranked in descending order so that the various portfolios may easily be constructed (Table 3). For example, the 60 percent probability portfolio is delineated by truckers, with a 60.01 percent probability. Every industry above truckers has a higher probability of outperforming the S&P 500. All industries below this have a lower probability. The broader 50 percent portfolio includes all industries above and including life insurance. The probability forecast for the fourth quarter of 1992 is reported in Table 3.

* * *

Table 3
Probability Forecast for Fourth Quarter 1992

	Probability Over Composite of Over 50%		Probability Over Composite of Under 50%
Commercial Services	99.90%	Communication Equipment Mfrs.	49.68%
Financial Miscellaneous	99.90	Telephone	48.22
Housewares	99.90	Oil Well Equipment & Services	48.01
Insurance Brokers	99.90	Coal	47.83
Manufacturing-Diversified	94.39	Property Casualty Insurance	46.69
Building Materials	88.84	Retail-Drug Stores	46.41
Health Care-Diversified	85.84	Conglomerates	45.91
Office Equipment & Supplies	84.64	Household Furnishings & Appliances	45.84
Hardware & Tools	81.16	Electrical Equipment	44.56
Containers-Paper	80.69	Gold Mining	42.42
Metals Miscellaneous	79.01	Foods	41.32
Computer Software & Services	75.80	Savings & Loan Assn. Holding	41.06
Machinery Diversified	75.80	Heavy Duty Trucks & Parts	40.84
Paper & Forest Products	75.80	Banks-Major Regional	39.86
Retail-General Merchandise	75.80	Health Care-Miscellaneous	38.86
Electronics-Defense	73.73	Machine Tools	38.24
Chemicals	71.55	Oil-Integrated International	37.84
Retail-Specialty	70.33	Airlines	37.40
Chemicals-Diversified	69.25	Railroads	35.51
Food Wholesalers	69.04	Household Products	33.78
Aerospace	67.57	Steel	29.26
Personal Loans	67.24	Entertainment	28.13
Containers-Metal & Glass	66.72	Natural Gas Distributors & Pipelines	26.35
Multi Line Insurance	66.37	Banks-Money Center	17.64
Beverages-Alcohol	65.46	Utilities-Electric Cos.	2.11
Hotel/Motel	63.83	Banks-Other Major	0.10
Beverages-Soft Drinks	60.94	Chemicals-Specialty	0.10
Automobiles	60.57	Retail-Specialty Apparel	0.10
Electronics-Instrumentation	60.37	Telecomm.-Long Distance	0.10
Truckers	60.01	Transportation-Miscellaneous	0.10
Retail-Dept. Stores	59.36		
Publishing-Newspapers	58.97		
Restaurants	58.89		
Pollution Control	58.61		
Manufactured Housing	58.02		
Hospital Management	57.22		
Textile Apparel	56.40		
Auto Parts-After Market	55.65		
Medical Products & Supplies	55.53		
Cosmetics	55.49		
Toys	55.02		

(Table 3 continued)

Table 3 (continued)
Probability Forecast for Fourth Quarter 1992

	Probability Over Composite of Over 50%
Aluminum	54.78%
Home Building	54.44
Publishing	54.38
Retail-Food Chains	53.77
Broadcast Media	53.65
Leisure Time	52.80
Tobacco	52.50
Shoes	52.29
Computer Systems	51.77
Oil & Gas Drilling	51.58
Engineering & Construction	51.27
Health Care-Drugs	51.24
Electronics-Semiconductors	51.23
Oil-Integrated Domestic	50.85
Life Insurance	50.71

A.B. Laffer, V.A. Canto & Associates

Economic Study

THE BUDGET DEFICIT

By Arthur B. Laffer and Victor A. Canto

*"Beauty is truth, truth beauty, - that is all
Ye know on earth, and all ye need to know."*

Lee Atwater, who managed George Bush's 1988 presidential campaign, told me how delighted he was when the Democrats went into orbit over the Republican vice presidential candidate, Dan Quayle. When I asked why he was so delighted at the unfounded hostilities the Democrats were heaping on Dan Quayle he said "Why Arthur, they're chasing the wrong rabbit." Making an issue of Dan Quayle guaranteed that the Bush/Quayle ticket would win. The opponents of the Bush/Quayle ticket were diverting their energies away from attacking Bush who was, after all, the presidential candidate. It allowed Lee to have a wide open field to savage Michael Dukakis. Well, since then Lee has died from a brain tumor and Bush is in deep voodoo. But we're all still chasing the wrong rabbit. And believe us when we tell you that the budget deficit is the wrong rabbit.

At our December 1, 1988 Conference in New York, Lee Atwater said:

"In the U.S. political process the winner takes all. Winning the presidency is the mandate, and the mandate was clear: no new taxes and a strong defense. As long as President Bush communicates with the people and talks common sense he will be fine. If the economy deteriorates, Bush will have a problem. Interest rates, inflation, trade and unemployment are the only issues voters understand. Protectionism and the deficit are too abstract for voters and will only become issues if they can be tied to the big four."

Lee Atwater also said:

"As long as the Republicans have the South they are in good shape. The Democrats cannot carry the South unless they have a Southerner at the top of the ticket."

At that same conference Michael Boskin said:

"I expect the budget to meet the Gramm-Rudman-Hollings target. I do not favor a tax increase, as there is no guarantee a tax increase would go toward reducing the deficit. I am cautiously optimistic and expect government spending to increase by about 4.5 percent. To deal with the budget deficit we have to enact spending controls. I believe in a supramajority for spending appropriations, and in tying together spending and revenue measures."

*And if you go chasing rabbits
You're looking for a fall
Tell 'em a hookah smoking caterpillar
Has given you the call
Go ask Alice
When she was just small.*

White Rabbit by
Jefferson Airplane

October 15, 1992

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THE BUDGET DEFICIT*

Bill Safire, as long ago as the early 1970s, referred to the budget as an assemblage of MEGO numbers. MEGO was his acronym for "my eyes glaze over." In 1970 I was fortunate to be appointed the chief economist at the newly-formed Office of Management and Budget. Even back then the OMB was the only place where \$0.1 stood for one hundred million dollars and where numbers less than \$50 million were rounded to zero. All in all it was pretty heady stuff and still is.

The study of fiscal policy is to economics what paleontology is to biology and astronomy is to physics. The numbers are very very big and outside the realm of personal experience. The subject is not intuitive.

But, in spite of the enormity of the budget numbers the laws of economics still hold. The true problem with issues such as the national debt and the federal deficit is being able to put those seemingly unfathomable numbers into perspective. Envisioning that stack of dollar bills going back and forth to the moon God knows how many times doesn't help anyone understand the national debt. Those types of analogies only instill panic in people and stop rational discourse. The importance of fiscal policy to the health and welfare of our nation necessitates that rationality triumph over emotion.

I. THE CONCEPT OF DEFICITS AND THE NATIONAL DEBT

A.) Static Analysis: Deficits Don't Matter, How Much the Government Spends Does!

Deficits can or cannot matter depending upon how they are viewed. But, there is one important sense in which deficits, the national debt and all those other MEGO numbers really don't matter. It truly doesn't matter whether the government taxes the money from you or whether it borrows the money from you with a promise never to repay. In either case you've lost the money and lost it for good.

When the world is viewed from this perspective what matters is how much money the government takes from you and not how it takes it from you. How much the government spends is the issue not how it finances that spending. Spending matters and matters a lot, but the choice between deficits and taxes doesn't matter. In this sense deficits really don't matter.

Several objections have been raised to this depiction of the proposition that deficits do not matter. The first objection relates to the fact that government debt bears interest in future years and taxes don't and that somehow these interest obligations make borrowing worse than taxes. A recent example of the "interest on the debt" hysteria comes from Charles Kuralt's depiction of Senator Warren Rudman. "Republican Senator Warren Rudman got so frustrated by Congressional inaction on this debt crisis that he announced he is retiring from the Senate. He doesn't want to be part of this any more. Not when the interest on the debt -- interest alone is \$200 billion a year."¹

But again, there really isn't any difference if the government taxes \$100 from you or borrows \$100 from you at a 10 percent interest rate and then taxes you next year for \$110 to pay off the interest and principle on the debt it owes you. Either way it's the same thing. In this context how government spending is financed really doesn't matter. Each and every combination of debt and interest and taxes over time still comes out to the same answer -- deficits don't matter.

In the words of Jack Kemp, people will just borrow to pay their taxes. Putting households into debt to get the government out of debt doesn't make sense.

Another objection to the proposition that deficits don't matter comes from those who love savings. They argue that budget deficits are dissavings pure and simple and that these deficits "crowd out" private investors from the capital markets. As a consequence interest rates rise and economic growth declines.

This argument, as stated, is o.k. but is misleading. It puts the "squeeze" on the capital markets as a deficit thing when in fact it is spending that "crowds out" investors whether financed by taxes or deficits. The logical misstep comes from extending the argument to justify tax hikes in order to reduce the deficit, government dissavings and crowding out.

Deficits, at least, as they are construed above, do crowd private investors out of the capital markets. However, taxation, even if it reduced deficits dollar for dollar, doesn't reduce this "crowding out" and doesn't increase total savings.

Imagine you had \$100 and the government borrowed that \$100 from you. It is true that you would have \$100 less to lend to private capitalists and that they would, in turn, be starved of the funds. But your ability to support private capital formation wouldn't change if the government taxed that same \$100 from you instead of borrowing it from you. In either case that \$100 of potentially investable funds would be gone. Private capitalists would still be starved of the funds just as if the government had run a deficit.

There is no difference between borrowing crowding out and taxing crowding out. In either case the capital market loses the \$100. Deficits in this context still don't matter. Crowding out relates to all spending and not just deficit spending.

B.) The National Debt and Interest on That Debt

Journalists collectively and individually have a little bit of knowledge which makes them both interesting and dangerous. They can really get a person going when they set their minds to it. But to start the process they need a perception and a myth. In this field of perception the amount of the national debt each American is liable for or interest on the national debt's share of the overall budget starts the process off just fine. Then a subtle implication that the note is coming due -- and soon -- puts the process in high gear.

Charles Kuralt, whose absence of other positive traits assures television viewers that he must be cerebral, by a process of elimination shows viewers that the average American family owes \$54,000 as its share of the national debt. He also pontificates that "interest on the debt -- interest alone is \$200 billion a year." Senator Warren Rudman then added, "That doesn't buy one meal for a homeless person. It doesn't do any AIDS research, doesn't build a bridge or build a new college building. It is money that goes, much of it, overseas. And it simply drains the economy of money that is of use to the American people."²

What nonsense! While every American family is on average responsible for \$54,000 of the national debt, the average American family also owns \$54,000 in government securities they otherwise would not have had. We do owe the debt to ourselves and it is therefore both an asset and a liability. Using a consolidated balance sheet it nets right out.

And to say we owe it to foreigners is not true. At the end of 1991, 16.5 percent of the total

debt was held by foreigners. For the years 1975, 1980, 1985, and 1990 the comparable numbers were 16.7 percent, 17.2 percent, 14.9 percent and 16.7 percent respectively. These types of assertions are quite unbecoming coming, as they do, from someone who supposedly holds the public trust.

Likewise, every dollar paid by the government in interest payments is received by Americans. Those interest payments aren't just expenses they're also income for Americans. To paint the picture of the federal debt as just a liability and not an equal sized asset is irresponsible journalism and dishonest scholarship. And just for good measure, it's clear that interest too is both an item of income and an item of expense.

C.) Growth: One Place Where Deficits Do Matter

In a static context it is a matter of indifference whether the government borrows your \$100 or taxes the \$100 from you. But in a dynamic growth context the difference between taxation and deficits can be as great as the difference between night and day.

Again, imagine the government has borrowed \$100 from you and you somehow discover a second \$100. You would then have a full \$100 to invest in the private capital markets. If, on the other hand, the government had raised your tax rates enough to take your first full \$100 they would lay claim on your second \$100 as soon as they found out you had it. Your incentive to discover that second \$100 will be considerably less if the government raises your tax rates versus borrows the money from you. Higher tax rates destroy the long-run rate of return on savings, investment, and capital formation.

In a dynamic growth context we come to what the Tiny Texas Taxer H. Ross Perot and the Tall Texas Taxer George H.W. Bush would see as an improbable conclusion. Deficits are clearly to be preferred to higher taxes. In a static context deficits don't matter. But, once growth is brought into the picture tax-financed spending will reduce growth relative to deficit spending.

The early 1960s was another period much as today where fascination with the Federal budget took on a life of its own -- probably as a result of the good economy and therefore a paucity of other things to complain about. Virtually all of the issues about which we speak today were heated topics back in the "go go" sixties including growth and the deficit. It's of more than passing interest to note how President John F. Kennedy came down on the issue:

"Tax reduction thus sets off a process that can bring gains for everyone, gains won by marshaling resources that would otherwise stand idle -- workers without jobs and farm and factory capacity without markets. Yet many taxpayers seemed prepared to deny the nation the fruits of tax reduction because they question the financial soundness of reducing taxes when the federal budget is already in deficit. Let me make clear why, in today's economy, fiscal prudence and responsibility call for tax reduction even if it temporarily enlarged the federal deficit -- why reducing taxes is the best way open to us to increase revenues."³

The reception a government receives in the capital markets is itself a sign of managerial competence. The recent downgrading of California debt after the state's huge tax increases is not just a bit of bad luck. It's the market's recognition of bad management. States are not taxed into prosperity. Well run governments, like well run businesses, are far more credit worthy than their counterparts.

D.) Is Borrowing Bad?

There is a general presumption that debt *per se* is bad. And because borrowing leads to indebtedness it therefore follows by the process of elimination that borrowing too must be bad. And this general perception persists in spite of the fact that we all know that under appropriate circumstances borrowing is either necessary or good. As a result we end up with a visceral bad feeling about borrowing and indebtedness. In truth, however, everyone loves his assets and hates his liabilities. People adore consumption and yet don't want to pay for it. They like getting paid for their services and never believe their wage excessive. When it comes to paying others however, they are far more likely to believe they've been overcharged and that the wages of others are excessive. It's only natural -- part of human nature at its best and worst.

Think for a moment about borrowing. How much should you borrow at say 2 percent *per annum* cost if you could lend risklessly at 10 percent *per annum*. There's no limit to how much debt you should incur. If, on the other hand, the rates were reversed you shouldn't borrow a penny. The issue is not borrowing. The issue is the spread.

President John F. Kennedy, in his Yale commencement address of 1962 (my graduating class), put this idea rather succinctly: "Moreover, debts public and private are neither good nor bad in and of themselves. Borrowing can lead to overtaxation and collapse -- but it can also lead to expansion and strength. There is no single simple slogan in this field that we can trust."

Whatever you may have thought and whatever others may tell you, deficits, borrowing and debt are not *per se* bad. It all depends upon what it costs you to get the money and what type of returns you can get when you use the money. Deficits really don't matter.

E.) The International Market: Once Again Deficits Don't Matter

In the original Latin the word deficit is a verb not a noun and when translated literally means "it is lacking."

However, in the context of the U.S. economy at least, the word deficit carries with it a sense of bloatedness, inefficiency and a state of being out of control. Therefore, the notion of twin deficits has to be that much worse. And so the code-word phrase "the twin deficits" surfaced during the 1980s as shorthand for the failure of Reaganomics.

According to these Reagan detractors a federal deficit crowds out private investors and pushes U.S. interest rates up. These higher interest rates in the U.S. attract foreign investors and push the U.S. dollar higher in the foreign exchanges. And, following the logic step by step the higher dollar makes U.S. goods less competitive in the global market place. U.S. imports rise, U.S. exports fall, and the U.S. trade balance careens into a deficit position all as a result of the federal budget deficit. Thus emerges the saga of the twin deficits.

One of the side consequences of this so-described problem of the twin deficit is that foreign owners of our government debt will be able to unduly influence U.S. policies and politics. As a result our policies will tilt away from what should be a policy of maximizing American interests toward foreign interests. In addition the twin deficits allow foreigners to accumulate assets in the U.S. and over time own more and more of America. Americans, so they say, will end up working for foreign corporations.

The arguments' initial premise of crowding out as discussed earlier is not correct. But even

if this initial premise were correct the rest of the argument just doesn't follow. If the federal deficit is contracted by raising taxes the total amount of funds available to the private capital market is completely unchanged. If deficits raised interest rates then taxes would raise interest rates by the same amount as well because there is no net differential impact on the domestic capital market. The existence of an international capital market doesn't change the economics.

Let's, for a moment, go back to Jack Kemp's description that taxes only put households into debt to take the government out of debt. The greater private debt should have the same capital market effect as would the same amount of public debt. If more public debt caused higher interest rates, foreign capital inflows, a strong dollar and a trade deficit, then greater private debt would do the same.

And also, as long as any portion of the U.S. national debt were held by Americans the foreigners would not even have to buy the newly-issued private debt but could instead buy some of the existing government debt from private bond holders. There wouldn't even be a credit worthiness difference. No matter how the issue is stretched between closed economies and international economies deficits just don't matter.

F.) Government Spending: Another Place Where Deficits Do Matter

Ronald Reagan's speech writers have always been the very best. But then again, they always had the very best public speaker to work with. In my experience over the years with Ronald Reagan and his speech writers I marveled at just how much give and take there was between him and his writers. He didn't just read what they wrote -- he helped write what they wrote. Ronald Reagan was no Charlie McCarthy.

One of President Reagan's best lines was given at the 1984 Republican convention in Houston, Texas. He stated that government spending was the real problem and that Congress was the cause of spending being out of control. He likened congressional spending habits to the spending habits of drunken sailors. He did note two differences however. First, sailors, he said, spent their own money. And, second, the next morning when the sailors woke up they were sober.

Reagan's style, while light and humorous, should in no way detract from the seriousness of his message. His basic point is that the government spends what it gets and then some. If the government believes that tax revenues are increasing they'll increase spending by that much and then a little more. On an intuitive level just imagine what would happen if Congress and the Administration raised our taxes next year by \$300 billion. There just ain't no way from here to Sunday that the actual deficit would fall by \$300 billion. This is the essence of the Reagan message.

First and foremost a tax increase of that magnitude would wreak havoc on the U.S. economy. The collapse of the economy that would result from such a large increase in taxes would, by itself, have the effect of reducing the tax base for collecting tax revenues. Even though tax revenues still might actually increase they would never increase by as much as the government projections would have them increase. Revenues would fall far short of expectations. This is one reason why the deficit won't fall by as much as expected.

Senator Edward M. Kennedy, in his 1980 attempt to wrest the Democratic party's Presidential nomination from Jimmy Carter said it and said it right: "Inflation and unemployment are the biggest spenders of all ... In candor, we must say that the Federal budget can be balanced only by policies that bring us to a balanced prosperity of full employment and price restraint."⁴

In addition, government spending is based on what the government expects revenues will be not on what revenues actually turn out to be. Spending is legislated at the beginning of the fiscal year and is predicated on what politicians believe their tax revenues will be. Therefore, spending increases will be greater and spending cuts smaller than what they otherwise would have been had taxes not been raised. This is yet another concrete reason why the deficit never falls by as much as the politicians would have us believe.

President Kennedy, referring to this same issue in 1962, made the following observation: "For the great enemy of the truth is very often not the lie - deliberate, contrived, and dishonest - but the myth - persistent, persuasive, and unrealistic. Too often we hold fast to the clichés of our forebears. We subject all facts to a prefabricated set of interpretations. We enjoy the comfort of opinion without the discomfort of thought."⁵

The final reason that puts the last nail in the coffin is that with such a tax increase and the concomitant slowdown in the economy automatic spending increases would be triggered without requiring any additional legislation. Higher unemployment would lead to higher government spending on unemployment compensation. Lower incomes would lead to more spending on welfare such as food stamps, aid for dependent children, rent subsidies, etc., etc. Lessened employment opportunities for people between the ages of 65 and 70 means that more of this age cohort will opt for social security benefits as opposed to working. Social security, therefore, also automatically increases government spending. And so the story goes. To paraphrase Robbie Burns "The best laid schemes o' mice and politicians gang aft a-gley."⁶

Perhaps here is where we should harken to the warning of Sir Robert Peel nearly one and one-half centuries ago.

"I cannot consent to any proposal for increasing taxation on the great articles of consumption by the labouring classes of society. I say, moreover, I can give you conclusive proof that you have arrived at the limits of taxation on the great articles of consumption . . . I advise you not to attempt taxation . . . for you will be defeated in your expectations of revenue."⁷

G.) Income Distribution: Yet Another Place Where Deficits Do Matter

It is hard to imagine any set of circumstances where deficits and taxes would have the exact same economic impact on the distribution of income now and into the foreseeable future. If for no other reason than some people who live for the here and now and have no regard for the future would prefer debt to taxation, there will be some difference. If the government borrows \$100 from someone instead of taxing that same person's \$100 this person can then sell the debt and consume more. True, for every person who consumes more there will be someone else who consumes less. Therefore, the net effect on consumption and savings will add up to no net effect. Yet who consumes and who saves will be very different and that is the essence of a distribution effect.

Deficit-financed spending will have a different distribution of effects than tax-financed spending will have.

As discussed earlier in the section on growth, growth in the periods where deficit-financed spending is employed will be raised relative to growth in the periods where tax-financed spending occurs. That is the primary reason why during periods of war deficits should be the preferred method of finance. After the war when elevated national output is not so crucial tax-

financed spending and even tax-financed debt reduction may be appropriate.

These dynamic differences between debt financing and tax financing of an economy also make a difference on the income distribution over time. Deficits do place an additional burden on future generations and reduce the burden on the current generation. If for no other reason, inheriting a large national debt restricts the freedom of various fiscal alternatives. The use of deficits vis-à-vis taxes can definitely change the timing of production and, as a result, the distribution of current and future incomes. While the timing effects are predictable, e.g., we know which periods' growth rates will be raised or lowered, the current and future income distribution effects are totally unfathomable. We do know that some people, industries, etc. will benefit relative to other people and other businesses. The process, however, is so complex and arcane that the sophistication of our analysis doesn't allow us to pinpoint which people and what businesses.

H.) A Reconciliation With the Keynesian Deficit Effect

In the eyes of Keynesians, spending financed by deficits or taxes have very different consequences for savings output and employment. People who have some of their income taxed feel poorer than people who have some of their income borrowed. The bonds held by people as a result of deficit spending are argued to be a form of wealth and lead to higher consumption spending. These same bonds, because they have market worth and a market yield, satisfy savers' desires to save without any corresponding investments.

Therefore, if the wish is to lower savings and encourage spending, then Keynesians would argue that we should use deficit financing. If, on the other hand, the wish is to increase savings and investment then we should finance spending with taxes. The choice seems clear.

But the choice is really far from clear. The increased bonds from deficit spending are, as they say, an asset in the hands of the owners. But the higher taxes required in the future to pay the interest and principal on the debt are also liabilities to the expected future taxpayers. In fact, every penny of either interest or principal paid to the holders of those bonds has to come from some taxpayer or another. Penny for penny and dollar for dollar the monies received by the holders of government debt are exactly equal to the additional monies paid by taxpayers. The present value of those interest and principal payments is the market value of government debt. The only difference between the debt and the discounted present value of the future tax liabilities is the diffuse nature of who is liable and the precise nature of who owns the debt. On balance the effect nets out to nothing.

If debt stimulates the holders of that debt to spend more, then it only stands to reason that the negative debt (the discounted value of the additional future taxes) to those liable for future taxes will contract spending by the exact same amount. The net difference on overall private spending resulting from deficit spending or spending financed by taxes is a great big zero. The argument is bogus.

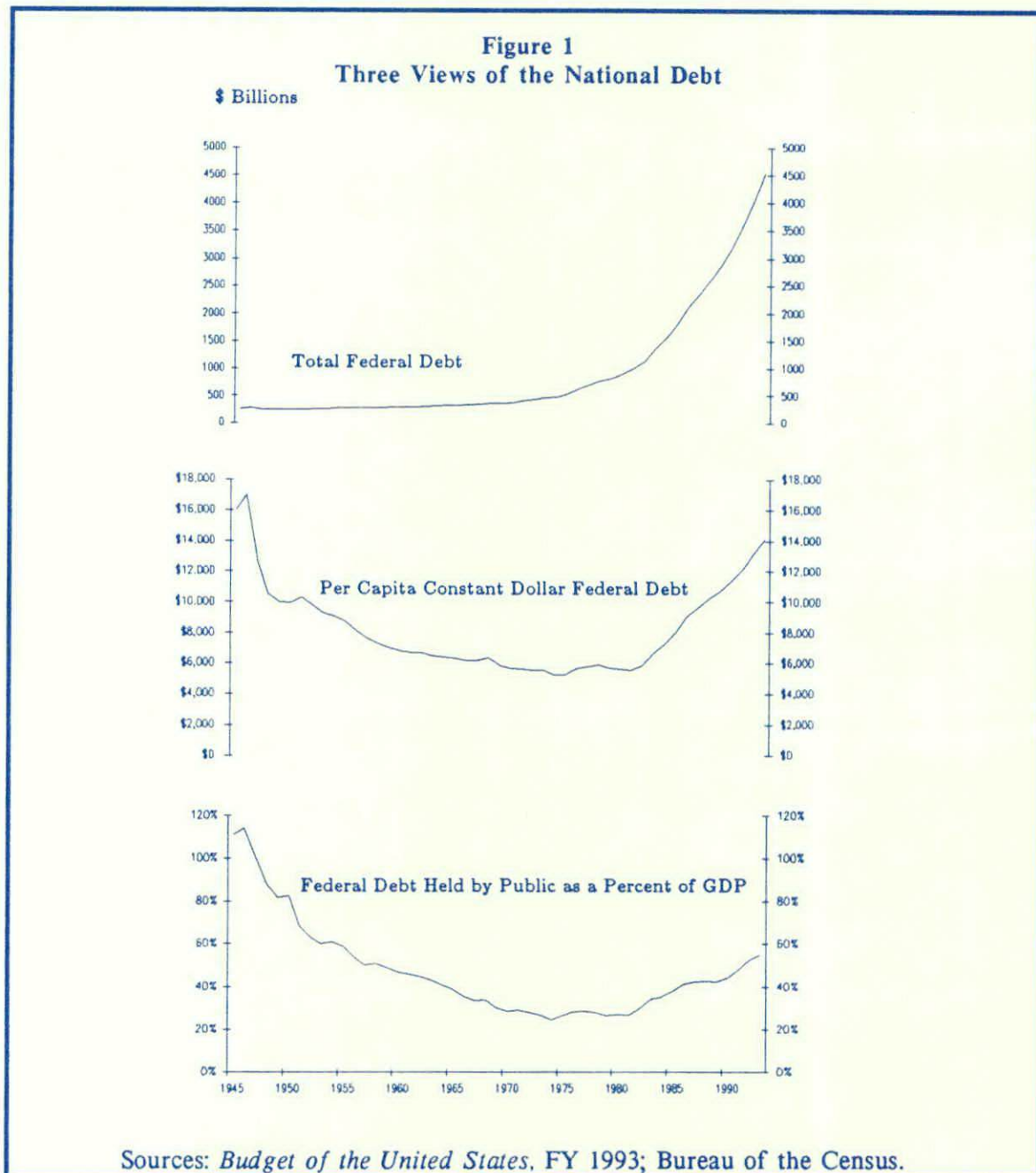
II. MEASURES OF THE DEBT AND DEFICITS

A.) The National Debt

Observing pundits flailing around in a sea of numbers can provide endless hours of enjoyment to those who understand what the numbers mean. Dilettantes who've never really spent enough disciplined time to understand the numbers rarely hesitate to use those numbers to bolster their

ill-conceived dogma. They even go so far as to use the word "prove" when statistics can never "prove." Cocktail *patois* by those who should know better but cannot resist occupying center stage and the mounds of masculine bovine defecation heaped on the unsuspecting public by thirty second sound-bite experts are perhaps the most entertaining of all. They just pretend to know and then they look the camera straight in the lens with their books and Ph.D. diplomas in full view. Maybe they do believe that their transparencies are somehow visible.

Let's start with the national debt. In the three graphs below are three very different images of the U.S. national debt. Each of the three graphs has essentially the same concept in mind but each is tendentious in its own right (Figure 1).



The top graph is a plot of the total current dollar national debt from 1945 to the present. The scale, the time period, and the lack of meaningful adjustments make this picture of our national debt exceptionally misleading.

To this notion, President John F. Kennedy had a direct response:

"Let us take first the question of the size and the shape of government . The myth is that government is big and bad -- and steadily getting bigger and worse.

Obviously this myth has some excuse for existence. It is true that in recent history each new Administration has spent much more money than its predecessors.

Thus President Roosevelt outspent President Hoover and, with allowances for the special case of the second World War, President Truman outspent President Roosevelt.

Just to prove that this was not a partisan matter, President Eisenhower then outspent President Truman by the handsome figure of \$182,000,000,000. It is even possible, some think, that this trend may continue.

But does it follow from this that big government is growing relatively bigger? It does not. For the fact is for the last fifteen years the Federal Government and also the Federal debt and also the Federal bureaucracy, have grown less rapidly than the economy as a whole."⁸

The middle graph makes some of the appropriate adjustments and as a result presents a different picture of our national debt. In the first place, the dollar value of the debt is adjusted for changes in the purchasing power of the dollar over time. A 1945 dollar was worth a lot more in terms of purchasing power than was a 1980 dollar. Therefore, any comparison of debt in 1945 to debt in 1980 has to account for changes in the purchasing power of the dollar. Nominal debt measures are totally meaningless.

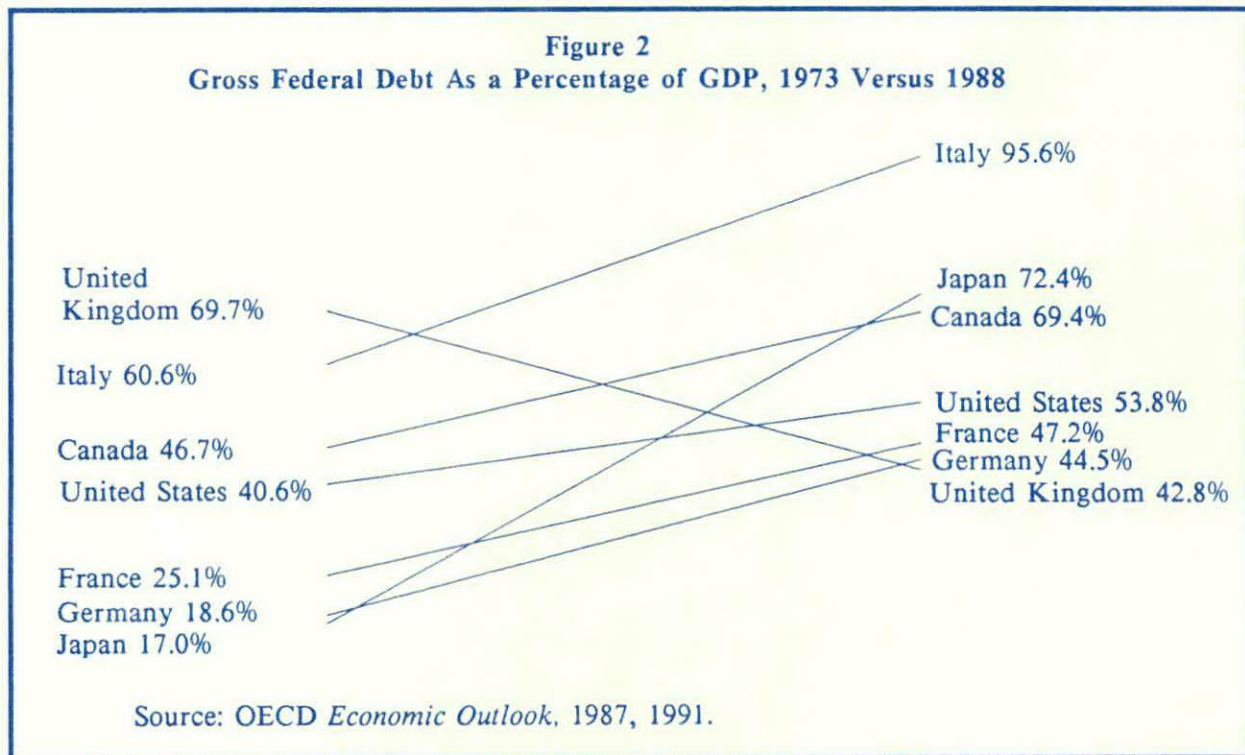
Likewise, an adjustment has to be made for the size of the population of the country as well. The national debt in 1945, for example, was the liability of a lot fewer people than was the national debt in 1990. *It only stands to reason* that debt should be adjusted for population too.

The third and final graph of this sequence paints a wholly different picture than either of the first two graphs. And, from every single analytic perspective, makes far more economic sense than either of the first two graphs.

In addition to adjusting for inflation and population, as was the case for the middle graph, graph three also adjusts for *per capita* income (the ability to pay as well as the number of payers) and eliminates the double counting of government debt held by agencies of the government. The third graph is far more appropriate than either of the other two graphs but is rarely seen. The first graph, which as a stand alone is virtually meaningless yet has the power to panic the ignorant, is to be found everywhere.

Another relevant measure of the national debt looks at the federal debt to Gross Domestic Product (GDP) ratio for the G-7 countries in both 1973 and 1988. This measure tries to incorporate a cross-country comparison as well as an over-time perspective. Once again the

picture painted just has to be a huge let-down to those who would have us go catatonic (Figure 2).



These measures of the national debt don't tell us whether we have a problem or not. But, they do tell us that if we do have a problem it is surely not out of the realm of past experience nor is it unique to the United States.

B.) The Deficit

The Federal budget deficit -- as reported -- is literally a meaningless number. And, whatever information is used in the compilation of the "deficit" surely doesn't correspond to the general conception held by the public, press and politicians. But let's start at the beginning.

The current unified budget of the Federal government includes prespecified federal cash outlays and cash receipts. The difference between these outlays and receipts is literally the on-budget federal budget deficit. This is The Number! In fiscal year 1992 the official federal budget deficit was \$449,125,000,000 (Table 1).

The most obvious of the adjustments to the official numbers is what they euphemistically call off-budget items. These are transactions that are literally legislated by Congress and approved by the President to be excluded from the budget totals. The existence of off-budget items represents the victory of politics over accounting. Appendix One of *The Budget for Fiscal Year 1993* says it all.

Since 1971, however, a number of off-budget Federal entities have been created. Off-budget Federal entities are federally owned and controlled, but their transactions are excluded from the budget totals by law. When a Federal entity is off-budget, its receipts, outlays, and deficit or surplus are not included

Table 1
Federal Government On-Budget Budget Totals
 (Billions of current dollars)

Fiscal Year	Revenue	Expense	Surplus
1953	\$65.511	\$73.771	\$-8.259
1960	81.851	81.341	.510
1970	159.348	168.042	-8.694
1980	403.903	476.618	-72.715
1990	749.652	1,026.713	-277.061
1992	774.784	1,223.909	-449.125

Source: *Budget of the United States*, FY 1993.

in budget receipts, budget outlays or budget deficits; and its budget authority is not included in the total of budget authority for the budget.⁹

For all analytic purposes off-budget transactions should be reincluded in the Federal budget (Table 2).

Table 2
Federal Government Off-Budget Budget Totals
 (Billions of current dollars)

Fiscal Year	Revenue	Expense	Surplus
1953	\$ 4.097	\$ 2.330	\$ 1.766
1960	10.641	10.850	-.209
1970	33.459	27.607	5.852
1980	113.209	114.329	-1.120
1990	281.656	225.065	56.590
1992	300.922	251.530	49.392

Source: *Budget of the United States*, FY 1993.

In fiscal year 1992 off-budget items resulted in a surplus of roughly \$49.392 billion. If this were included in the Federal budget numbers, as it should be, the overall federal budget deficit would be \$399.733 billion in fiscal year 1992 instead of the reported \$449.125 billion deficit.

But this explicit exclusion of these so-called "off-budget" items is far from the only omission from the federal budget numbers. Take, for example, the federal budget's failure to distinguish between capital and current expenditures.

Whether we're concerned with accounting for individuals, businesses or governments, generally

accepted accounting practices require that expenditures for capital purposes be treated differently than current expenses. Not to be trite, capital expenses are capitalized and are excluded from the profit and loss statement. If companies had to report capital expenditures as expenses there isn't a fast-growing company in the country that could turn a profit.

In the same vein, all state and local governments in the U.S. recognize that capital purchases should be excluded from the reported deficit or surplus numbers. And, as a result, they all do keep systematic accounts for capital and current purposes. Unfortunately, the federal government is not quite so enlightened. Federal government expenditures whether "on budget" or "off budget" fail to discriminate between capital and current expenditures. And yet, it is patently obvious that a significant portion of federal expenditures are for capital purposes.

While few would dispute that federal expenditures for highways, education, and research and development are capital expenditures, a reasonable case can also be made for defense spending, social security and health expenditures. But whatever the specifics a significant portion of federal expenditures are capital expenditures.

While I surely don't know with any degree of exactitude what portion of total federal expenditure are capital and what portion are current I do know the capital portion is not zero. To provide a range, the table below shows estimates of federal capital expenditures. The numbers are substantial (Table 3).

Table 3
Estimates of Federal Capital Expenditures
(Billions of current dollars)

Year	Federal Spending On Public Physical Capital	Federal Spending On Conduct Of R & D	Federal Spending On Conduct Of Education and Training	Federal Spending On Capital Less Education And Training
1953	\$22.958	1.848		24.806
1960	22.405	7.322		29.727
1970	33.186	15.153		48.339
1980	63.021	30.235	23.869	93.256
1990	128.599	63.81	28.986	192.409
1992	127.354	70.855	37.98	198.209

Source: *Budget of the United States*, FY 1993.

In fiscal year 1992 federal capital expenditures were \$198.209 and should not have been included in the federal budget deficit. This adjustment plus the adjustment for the "off budget" surplus would take the \$449.125 billion official deficit number down to \$201.524 billion. And, this capital expenditure adjustment is totally necessary. Any reporting of a federal budget deficit without adjusting for capital expenditures is flat out wrong.

Yet another adjustment to be made at this time is the impact inflation has on the overall budget numbers. The government debt held by the public is a liability of government and is denominated in nominal or what they call current dollars. While this nominal amount might

not change, an increase in the overall price level will reduce the real value of that debt. The reduction in the real value of that debt is just as much a revenue item (an inflation tax) or an expenditure reduction (reduced interest cost) as any other tax increase or expenditure cut. The inflationary impact on budget numbers is as real as any of the official numbers and should be included in the budget totals.

Were these inflation tax revenue numbers to be included they would be a direct dollar for dollar reduction in the federal budget deficit. These numbers are not small even in terms of the federal budget. In the table below I have listed this inflation tax for selected years (Table 4).

Table 4
Reduction in Real Federal Debt Held by the Public Due to Inflation

Fiscal Year	Debt Held By Public Billions of Current Dollars	June/June Inflation	Reduction Due to Inflation Billions of Current Dollars
1953	\$ 218.4	1.1%	\$ 2.427
1960	236.8	1.7	4.037
1970	283.2	6.0	16.714
1980	709.3	14.4	92.003
1990	2,410.4	4.7	102.287
1992	3,077.3	3.1	83.034

Sources: *Budget of the United States*, FY 1993; U.S. Department of Labor.

Note: Prior to FY 1977 the federal fiscal year began on July 1 and ended on June 30.

In fiscal year 1992 this inflation tax on the federal debt would have amounted to \$83.034 billion and should be deducted directly from the reported official budget deficit number to arrive at a more correct number. This adjustment to the deficit in conjunction with the aforementioned adjustments would take the official number of \$449.125 billion deficit down to a deficit of \$118.49 billion. And this inflation tax on the holdings of the federal debt is completely appropriate for inclusion for proper accounting.

There are lots and lots of additional considerations that would have an impact on what should be reported in the federal budget deficit. Some may even be of substantial magnitude and they could cut either way -- either increasing or reducing the overall deficit. In a later section a few of these other considerations will be enumerated briefly. Unfortunately, their impact is far from clear. But one additional set of considerations is both clear and appropriate.

The next most obvious adjustment is to look at all levels of government and not solely the Federal government. State and local governments have an enormous impact on spending, taxation, and deficits. They aren't merely some minor item insignificant in the grander scheme of things. State and local governments, while in aggregate not quite the size of the Federal government, are very much the same dimension. Again, for any analytic purpose, state and local government should be included on a par with the Federal government.

In the table below state and local budget surpluses are listed for selected years. Because state and local governments already segregate capital from current budget adjustments no adjustments are needed on this count (Table 5)

Table 5 State and Local Government Budget Totals (Billions of current dollars))			
Fiscal Year	Revenue	Expenditure	Surplus
1953	\$ 22.1	\$ 21.7	\$.4
1960	40.0	39.6	.4
1970	100.2	96.6	3.6
1980	266.5	243.2	23.3
1990	582.9	553.4	29.5
1992			25.0*
* Estimate			
Source: <i>Budget of the United States</i> , FY 1993.			

In fiscal year 1992 state and local governments ran a cumulative budget surplus of \$25.0 billion which should be deducted from the overall budget deficit that we have already calculated. This adjustment to the budget deficit along with the adjustments I've already made would further reduce the official budget deficit reported as \$449.125 billion down to a \$93.49 billion deficit. There is simply no argument against including the state and local budget adjustment to the overall deficit figure. It is the right thing to do.

The final adjustment I'm going to make in this section of this paper is the state and local government equivalent of the inflation tax on total indebtedness. State and local governments have over the years issued substantial amounts of debt which now is held by the public at large. Inflation results in a tax on these debts and should be included in the budget numbers. While a case can be made that this inflation tax should be added to revenues an equally cogent case can be made that it should be deducted from interest outlays. Whichever adjustment ultimately prevails does not affect the undisputed fact that this inflation effect on state and local debt should be included to reduce the overall reported budget deficit. In the table below this effect is shown for a number of selected years (Table 6)

Table 6 State and Local Net Debt Reduction Due to Inflation (Billions of current dollars)			
Fiscal Year	State and Local Debt	June/June Inflation	State and Local Debt Reduction Due to Inflation
1953	\$ 33.782	1.1%	\$.341
1960	69.955	1.7	1.101
1970	143.570	6.0	8.027
1980	335.603	14.4	43.744
1990	860.584	4.7	37.346
1992	1,295.238*	3.1	40.000*
* Estimate			
Sources: <i>Historical Statistics of the United States; Government Finances</i> , U.S. Department of Labor.			

In fiscal year 1992 the decline in the purchasing value of state and local indebtedness was approximately \$40.0 billion and conceptually should be subtracted from the overall deficit of all governments. If this number were properly accounted for along with our earlier adjustment what at first glance appeared to be a deficit of \$449.125 billion or 7.7 percent of Gross Domestic Product turns out to be a deficit of \$53.49 billion or slightly under 1 percent of GDP. Quite a difference!

But fiscal year 1992 was an exceptionally bad year for these adjustments. In the table below I have listed the reported official budget deficits and their corresponding share of Gross Domestic Product alongside the more correct deficit or surplus numbers. The differences are astounding and should put to shame all deficit mongers from Martin Feldstein to H. Ross Perot. Eat your heart out Charles Kuralt (Table 7).

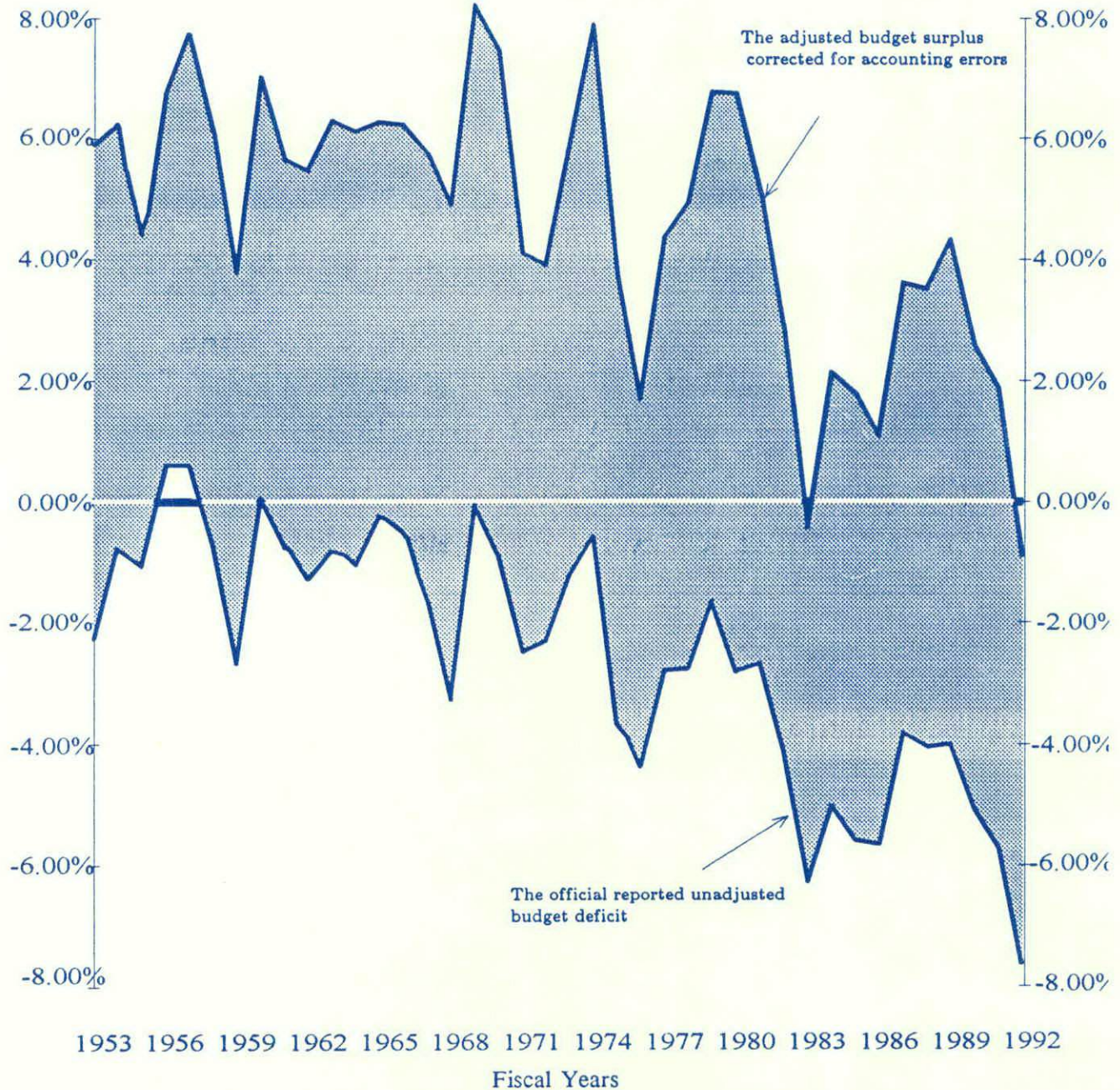
Table 7
The Adjusted Budget Deficit
(Billions of current dollars)
(Deficit as Percent of GDP in Parentheses)

Year	On Budget Federal Surplus	On Budget Surplus Adjusted for Off Budget	On Budget Surplus Adjusted For Off-Budget And Federal Capital Expenditures	On Budget Surplus Adjusted For Off-Budget Capital Expenditures And Inflation On Net Federal Debt	On Budget Surplus Adjusted For Off-Budget, Inflation On Net Federal Debt, Federal Capital Expenditures And State And Local Government Surplus	On Budget Surplus Adjusted For Off-Budget Inflation On Net Federal Debt, Federal Capital Expenditures State and Local Government Surplus And Inflation On State and Local Debt
1953	\$ -8,260 (-2.3%)	\$- 6,493 (-1.8%)	\$ 18.313 (5.0%)	\$ 20.740 (5.7%)	\$ 21.140 (5.8%)	\$ 21.481 (5.9%)
1960	510 (0.1)	301 (0.1)	30.028 (5.9)	34.065 (6.7)	34.465 (6.8)	35.566 (7.0)
1970	-8,694 (-0.9)	-2,842 (-0.3)	45.497 (4.6)	62.211 (6.3)	65.811 (6.7)	73.838 (7.5)
1980	-72,715 (-2.7)	-73,835 (-2.8)	19.421 (0.7)	111.424 (4.2)	134.724 (5.1)	178.468 (6.7)
1990	-277,061 (-5.1)	-220,470 (-4.0)	-28.061 (-0.5)	74.226 (1.4)	103.726 (1.9)	141.072 (2.6)
1992	-449,125 (-7.7)	-399,733 (-6.8)	-201.524 (-3.4)	-118.490 (-2.0)	-93.490 (-1.6)	-53.490 (-0.9)

Source: Budget of the United States, FY 1993.

For the whole period a plot of the reported "on budget" deficit is shown and each of the adjustments for the period 1953 to 1992 (Figure 3).

Figure 3
Budget Deficit -- Unadjusted to Adjusted --
As a Percent of GDP, FY 1953-92



Sources: *The Budget of the United States*, FY 1993; *Government Finances*; *Historical Statistics of the United States*.

C.) Other Considerations

The government, whether it be the federal government, state government, or local government, can impact the vitality of the economy in many ways that are not included in the budget proper or even in the adjustments I've already made. In some very real sense these are also budgetary items. While I really don't intend to spend a lot of ink on these additional items that decision should be interpreted more as a reflection of my ignorance rather than as their lack of importance.

Of the many items that are not to be found in the "on budget" or "off budget" Budget we have i.) direct government loans, ii.) government guaranteed loans, iii.) federal deposit insurance, iv.) pension benefit guarantee corporation, v.) other insurance, vi.) government sponsored enterprises, vii.) unfunded liabilities of federal programs, viii.) non-budget agency debt, and finally, ix.) regulations.

To give you a sense of the magnitude of these items, at the end of 1991 federal and federally assisted credit amounted to \$6,272.0 billions. Of the total net borrowing in the U.S. credit market, 85.4 percent was accounted for by federal borrowing plus guaranteed borrowing plus the borrowings of government sponsored enterprises. The federal government wasn't "chopped liver" in the lending market either.

However, before I get carried away with the sins of my enemies the following table lists the face value of federal credit and insurance programs (Table 8).

Table 8 Face Value of Federal Credit and Insurance Programs (In billions of dollars)			
	Face Value 1991		Face Value 1991
Direct Loans:		Federal Insurance:	
Farmers Home	\$ 52	Deposit Insurance:	
REA and RTB	39	Commercial and Savings Banks	\$ 1,942
Export-Import	9	Thrifts	654
AID	21	Credit Unions	197
P.L. 480	12	Total Deposit Insurance	\$ 2,793
Foreign Military Financing	9		
Small Business	7	PBGC	900
Other Direct	5	Other Insurance	750
Inactive	20	Total Federal Insurance	\$ 4,443
Total Direct Loans	\$ 174		
Guaranteed Loans:		GSEs:	
FHA Single-Family	\$ 301	Freddie Mac	\$ 369
VA Mortgage	158	Fannie Mae	456
FHA Multi-Family	77	FHL Banks	107
Guaranteed Student	57	Sallie Mae	-
Small Business	14	FCS	74
Farmers Home	6	Total GSEs	\$ 1,006
Export-Import	6		
CCC Export Credits	4	TOTAL	\$ 6,272
Other Guaranteed	7		
Inactive	19		
Total Guaranteed Loans	\$ 649		

Source: *Budget of the United States, FY 1993*

The above table really puts some of the issues in stark relief. And while a careful person should always be wary of believing what the numbers say in this case there is a message.

Other considerations come when we look at the unfunded liabilities of major public and federal employee retirement programs. In the table below are listed the major programs. Caution should be heeded in the listing of the Social Security-OASDI unfunded liability. The methodology used by the government grossly understates the actuarial deficiency (Table 9). *Caveat Emptor*.

Table 9
Actuarial Deficiencies of Retirement Annuity and Health Programs
(In billions of dollars)

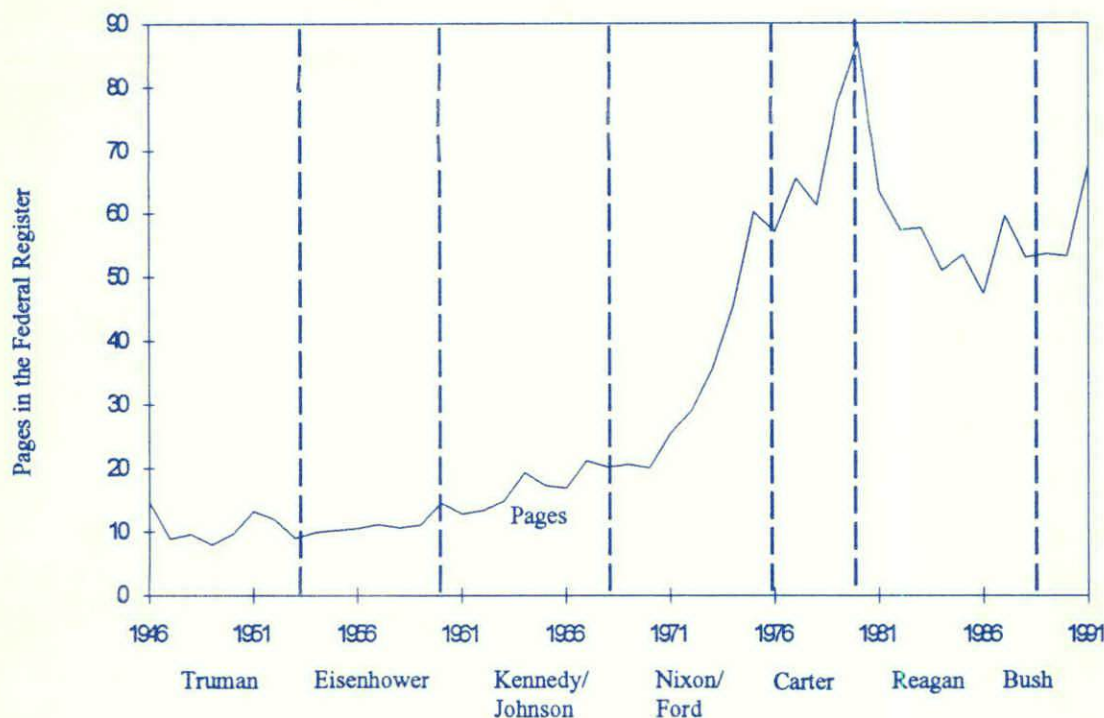
Annuity Programs:	
Social Security - OASDI	\$ 1,111
Civil Service Retirement System	660
Military Retirement System	533
Federal Employees Retirement System	6
Railroad Retirement Board	33
Other Retirement Systems	21
Health Programs:	
Medicare-HI	402
Federal Employees Health Benefits Program	115
Military Treatment Facilities and CHAMPUS	295

Source: *The Budget of the United States*, FY 1993.

Some government agencies are allowed to issue debt that is not subject to the overall debt limitations of the federal government nor is it reported in the budget. Almost all of the net amount of \$15.0 billion in fiscal year 1991 was accounted for by the Federal Deposit Insurance Corporation Bank Insurance Fund and the Federal Savings and Loan Insurance Corporation Resolution Fund. It is only because we have become so immersed in huge numbers, inconsistencies and outright deception that this \$15 billion figure could seem "ho hum" to us. In reality it's huge and it's an outrage.

The last of the unusual items is the budgetary equivalence of federal regulations. In 1990 relying on the work of Thomas D. Hopkins, the U.S. Budget reports that the costs of federal regulation (not including state and local) in 1990 were somewhere between \$430 billion and \$562 billion.¹⁰ These numbers are in the range of 35 percent to 45 percent of total federal spending. But the graph below says it all (Figure 4).

Figure 4
Number of Pages in the Federal Register



Source: Marvin Zonis & Associates

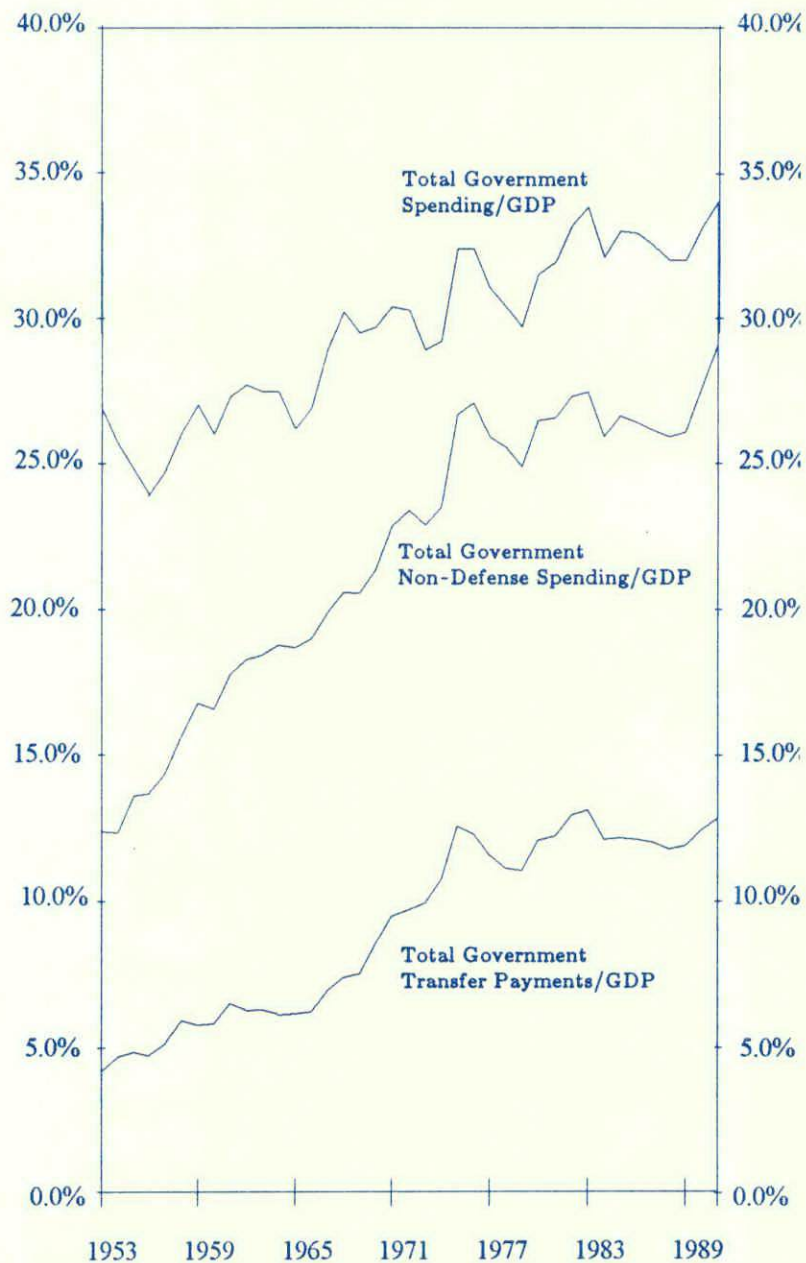
D. Spending.

"... I favor any and all tax cuts, even when the particular cuts are not my first choice. Reducing revenue available to Congress is the only effective way to limit spending. Experience has shown that Congress will spend as much as the tax system raises plus as much more as it can get away with, which unfortunately, has been a rising, though still limited, amount."¹¹

In the space of a little over a third of a century total government spending as a share of Gross Domestic Product has risen dramatically (Figure 5).¹² At its near-term low in 1956 government's share of total output was about 24 percent and by 1992 it was about 34 percent. While the yearly numbers display significant variability there is a powerful trend. In my opinion it is this trend that should be the focus of current policy discussions. Discussions of the deficit only obfuscate the real issue which is the size of government.

A far more alarming picture of government spending is clearly visible when we look at total government spending ex-defense as a share of GDP. In 39 years this ratio has gone from 12.5 percent of GDP to 29 percent of GDP. Again, it borders on the impossible to ascertain just what the right numbers should be at any one moment in time, but it is clear that the actual number is displaying a powerful trend. From the mid-1970s to the end of the Reagan era the volatility remained high but the trend appears to have vanished. However, with the Bush Presidency the trend is back.

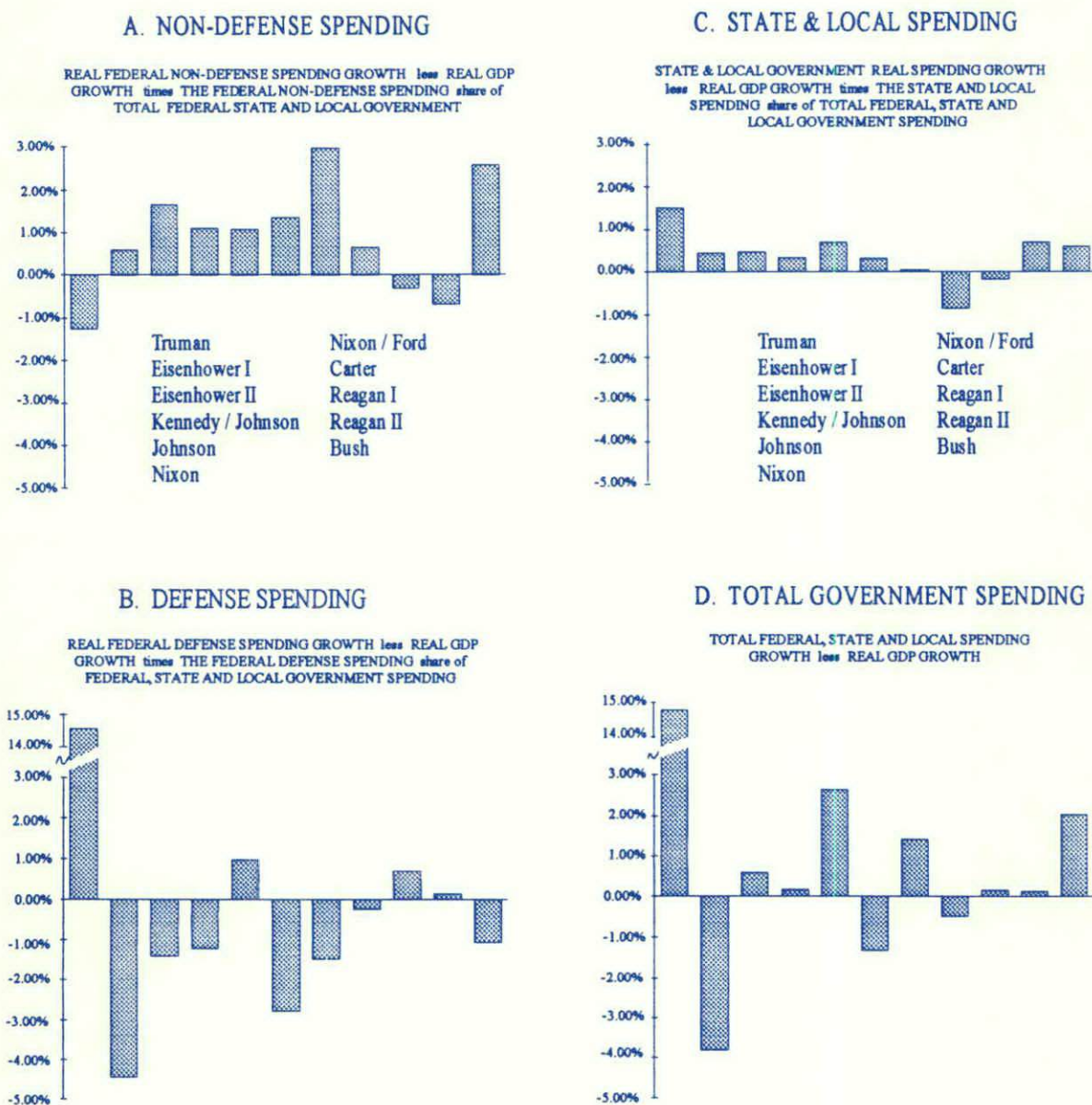
Figure 5
Government Spending as a Percent of GDP, 1953-92



Source: *The Budget of the United States*, FY 1993; National Income and Product Accounts.

Individual components of overall spending is only one of many ways of ranging the spending issue. What I have found to captivate the attention of most people who are involved in the political process is what happened to the spending to GDP ratio by administration. In the four bar charts below I have plotted non-defense, defense, state and local and total spending growth relative to GDP by administration. To assure comparability each category of spending has been multiplied by its share of total spending. Thus, the bars are strictly additive by administration (Figure 6). Enjoy!

Figure 6
Spending Growth Relative To GDP By Administration



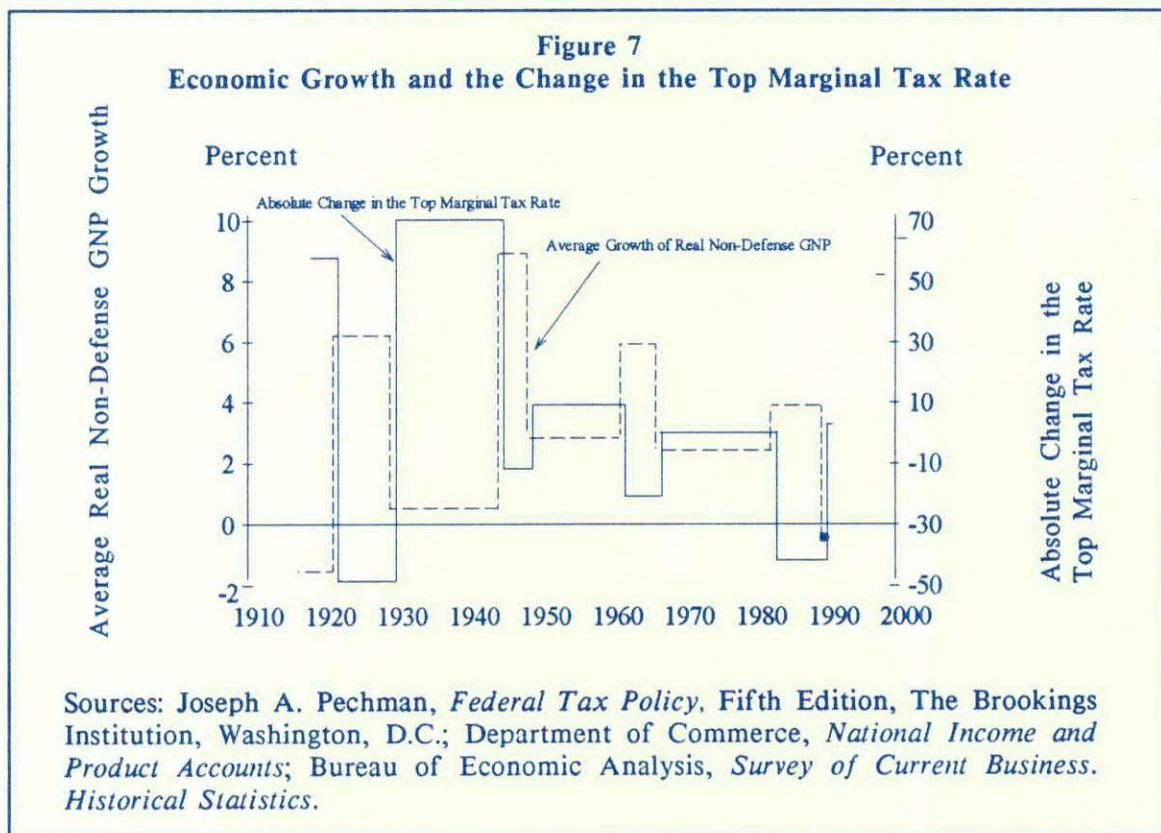
Sources: Budget of the United States, FY 1993; National Income and Product Accounts.

E.) Growth and Taxes

A reasonable discussion of debt and the deficit cannot be held in a vacuum. The issues are too important. After all the hysteria has passed and the left side of the brain is fully activated the actual impact deficits, debt, taxes, and spending have on the economy now and in the future is the question at hand.

We all have tons of anecdotal evidence to support all sorts of positions depending upon our opponents and audiences. My historical favorite has always been to point to the post-war economic performance of both Germany and Japan as examples of what tax rate cuts can do for growth and then juxtapose these results with those of the U.K. and the U.S. The 1980's emergence of Thatcher in the U.K. and Reagan in the U.S. and the reversals of fortune in Germany and Japan as well have diluted this anecdote.

But after all is said and done the graph below best illustrates my view of tax rates and growth. Here we have the combined experience of the United States from 1918 to 1992. All we've done is plot average annual real non-defense growth in output against changes in the highest marginal Federal tax rate for periods of continuous tax changes. Let the evidence set you free. (Figure 7).



FOOTNOTES

- * The authors would like to thank Gerald Warren, David Siphron and George Keane for inspiration if not perspiration. We are sure that they do not wish to be held liable for the contents contained herein.

1. Charles Kuralt segment of "Sunday Morning" program of September 13, 1992, dealing with the National Debt.
2. *Ibid.*
3. John F. Kennedy, President of the United States, *Economic Report of the President*, 1963.
4. Senator Edward M. Kennedy, address to the Democratic National Convention, 1980.
5. John F. Kennedy, President of the United States, Commencement Address at Yale University, June 11, 1962.
6. Paraphrased from Robert Burns (1759-1796), "To A Mouse."
7. Sir Robert Peel before the House of Commons, March 11, 1841, *Hansard's Parliamentary Debates*, 3rd Series, Vol. LXI, pp. 431-432.
8. John F. Kennedy, President of the United States, Commencement Address at Yale University, June 11, 1962.
9. *The Budget for Fiscal Year 1993*, Appendix One, page 147.
10. Thomas D. Hopkins, "Cost of Regulation," Rochester Institute of Technology Public Policy Working Paper, December 1991.
11. Milton Friedman, "Oodoo Economics," *The New York Times*
12. Trusting that we don't have to revisit the complex error of nominal dollars but can instead stay with the simple truth of budget numbers normalized by GDP, we can now look at spending.

APPENDIX
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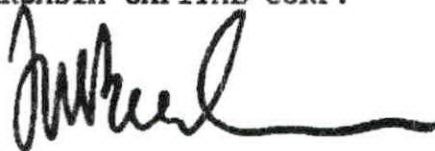
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The five words: "READ CLINTON'S LIPS, NEW TAXES!"

Good luck.

Sincerely,

ARCADIA CAPITAL CORP.



Frederick Wm. Bierwirth, II
President

FWB/hs

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OCT 29 '92 11:05 LETHAN BROS' FIDSALE

AMERICAN NUT.

NO. 727

101

P.3

OFFICIAL APPLICATION FOR RESIDENCY IN ARKANSAS

NAME: _____ NICKNAME: _____ CB HANDLE: _____
 YORE MAMA: _____ YORE DADDY (IF KNOWN): _____
 SHADE OF YOUR NECK: Light Red: _____ Medium Red: _____ Dark Red: _____
 NAME ON YO PICKUP: _____
 TRUCK EQUIPMENT: Gun Rack: _____ Coon Tail: _____ Pit Bull: _____ Spl. Cap: _____
 Rebel Flag: _____ Ferry Dice: _____ Naked Broad Sox on Mirror: _____
 FAV-O-RITE RECREATION: Drinkin': _____ Bull Chop Throwin': _____ Possum Huntin': _____
 Craw Dad Humdin': _____ Splittin' Backy: _____ Other: _____
 WEAPONS OWNED: Tear Arn: _____ Pick Handle: _____ Log Chain: _____ Knuckle: _____
 Beer Bottle: _____ Scatter Gun: _____
 NUMBER OF DOGS OWNED OVER 10: _____ NUMBER OF WEEKS UNEMPLOYED: _____
 WHICH OF THE FOLLOWIN APPLIENCES DO YEW HAVE IN YORE YARD:
 Fridgefreezer: _____ Heatin Stove: _____ Warshert: _____ TV: _____ Freezer: _____
 DO ANY OF THE ABOVE APPLIENCES WORK? Circle: 1 2
 HOW MANY OLD CARS ON BLOCKS IN FRONT YARD: _____
 WHEN WAS YORE LAST ELVIS SIGHTING: _____
 HOW MANY HOMEMADE TATTOOS ON YEW: _____ Where: _____
 ARE YEW MARRIED TO ANY OF THE FOLLOWING: Sister: _____ Cousin: _____
 DO YEW KNOW HER NAME: Yup: _____ Nah: _____
 WHICH WEIGHS MORE, YORE WIFE OR PICKUP TRUCK: Wife: _____ Truck: _____
 AT YORE HOME, WHICH STINKS THE MOST: Wife: _____ Hog Pen: _____ Outhouse: _____
 CAN YEW SPELL YORE NAME RIGHT EVERY TIME? Yup: _____ Nope: _____
 DOES YORE BABY SLEEP IN THE BOX THE TV CAME IN: Yup: _____ Nope: _____
 HAVE YEW EVER STAYED SOBER FOR A WHOLE DAY? Nope: _____
 DO YEW KNOW ANY WORDS WITH MORE THAN 4 LETTERS: Yup: _____ Nope: _____
 DESCRIBE THE DIFFERENCE BETWEEN A 'TATER' AND A 'MATER': _____
 WHICH IS CORRECT: "I SEED HIM" or "I SEEN HIM"? _____
 HIGHEST LEVEL OF EDUCATION ACHIEVED: First Grade: _____ Second Grade: _____
 HOW MANY CARTONS OF CIGARETTES DO YEW SMOKE A DAY: _____
 MATH TEST: HOW MANY FOOD STAMPS DO THE FOLLOWIN COST:
 Six Pack: _____ Plug Backy: _____ Shotgun Shells: _____ Ciggies: _____
 Prostitute: _____ Lid of Grass: _____
 HEALTH QUESTIONAIR: WHICH OF THE FOLLOWING DO YEW HAVE:
 Head Lice: _____ S.O.B.: _____ Crab: _____ Rusty Nose: _____
 CAN YEW REMEMBER WHEN YEW LAST TOOK A BATH? Yup: _____ Nope: _____
 I Hereby swear that this is the vooth and sign my "X" on this _____ day of _____ 1992

X

Posi-Net brand fax transmittal memo 7871

To: Fred Smith	From: David
Dept:	Phone #
Fax #	Fax #

608-234-1003

SARA BEHMAN, PH.D.
240 NORTHCREEK CIRCLE
WALNUT CREEK, CA 94598-1317

(510) 945-4960

Central Files: no response
necessary. 11/2

October 26, 1992

Mr. Robert B. Zoellick
Deputy Chief of Staff
The White House
Washington, DC 20006

Z, she has written before; you have responded.
No need to respond again, I'd think.
Thought you might want to see this. CDJ 10/28

OK

Dear Mr. Zoellick:

After hearing the growth rate of GDP this morning, I decided that it might be worthwhile to give you the insights I have on the California labor market.

As you know, the California unemployment rate is about two points above the national unemployment rate. This was the general situation for California until the end of the 1970's and prompted the research paper I am sending you. Various conferences were held to determine why this was the case and the result of one of these conferences is that I was assigned the task of doing research on the subject. (See page 186 of the paper.)

My background was such that I not only had a Ph.D. in economics, specializing in labor economics, but prior to obtaining the Ph.D. I was a labor market analyst in the State of California for 10 years. Hence, I had quite intensive knowledge about the California labor market.

What I learned from this research were basically two things:

1. Climate, an amenity, and net migration were two variables that kept the differential high. But when the economy generally was OK, and manufacturing and construction were growing, it would appear that the growing labor force could be absorbed and the differential between the national rate and the California rate were about wiped out.

2. However, the situation started to change by 1977.

I did not follow up on this as I had many other responsibilities. However, as you can see, the differential in the 1980's was wiped out. The graph (Figure 2) shows that the California and national unemployment rates tracked each

other pretty well until mid-1990. It is of interest that the NBER says that the recession started in July 1990. Why did the California rate track the national rate until about mid-1990? My guess is that with the national economy growing as the country during the 1980's was expanding for 92 months (Nov. 1982-July 1990), the country's largest peactime expansion, migration to California could have slowed and, or, with California also growing the migrants were easily absorbed. I prefer the latter explanation because between 1982 and 1990, construction employment in California went up from 349,000 to 650,400 (a gain of 305,400 jobs, or 86.4 percent).

Manufacturing employment increased between 1982 and 1990 from 1,957,700 to 2,126,800, or by 8.6 percent (an increase of 169,100 jobs.) But defense cutbacks were probably already having their effect because California manufacturing employment peaked in 1989 at 2,161,400.

What has happened since mid-1990? The divergence between the California unemployment rate and that of the nation has widened to about a two-point differential.

Now, why is that? If one follows the findings in my research paper then it is a pretty good assumption that the recent downswings in California's construction and manufacturing industries cannot wipe out the historic two-point differential. (The detail is below.)

Another important finding in my paper is that it took about two to three years for defense cutbacks to be absorbed by a state's economy. My study of the residuals from the regression analysis (see page 184 of the paper) notes this insight.

As I have not followed detailed statistics of the most recent defense cutbacks I do not know how severe they have been relative to prior ones. However, I suspect that California's defense cutbacks must have been quite severe relative to prior ones, with Southern California especially hard hit because that is where most of the manufacturing of defense items has taken place.

The following table is instructive:

California employment

Industry	1988	September 1992	Percent change
Aircraft mfg.	163,600	129,300	- 21.0
Guided missile mfg.	81,900	58,200	- 28.9

Instruments mfg.

247,700

204,400

- 17.5

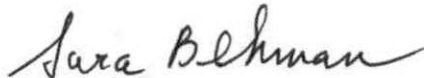
Besides the problem of defense cutbacks, construction is in very bad shape in the state. In 1990, employment in this industry peaked at 650,400. This was the highest annual average in California history. But, by September 1992, employment in construction was at 521,000. So here we have a loss of 129,400 or 19.9 percent.

As you obviously know, construction and manufacturing have the largest multiplier effects. So, California has had a double whammy.

You must understand that I have been retired from professional responsibilities for about three years, but nowhere have I seen clear explanations of what is going on in our labor markets. I strongly believe that problems can be tackled only if we know the right questions. And the right questions can be asked only if we have a thorough understanding of economic history.

I do know the California labor market and perhaps this background could be of some value even now.

Sincerely,



Sara Behman

ENCLOSURES

1. Paper- "Interstate Differentials in Wages and Unemployment"
2. 3 pages from "Labor Market Conditions in California," Oct 2, 1992
3. 5 pages from Economic Report of the Governor 1992" (California)

Interstate Differentials in Wages and Unemployment

OVER THE SIX-YEAR PERIOD 1970-1975, the structure of unemployment rates (based on the Current Population Survey) in the 27 largest states remained remarkably stable (see Table 1). Such persistency in interstate unemployment differentials invites investigation: why haven't the equilibrating forces of relative wages and worker mobility eliminated the unemployment differentials among the states? The research presented here is an initial exploration which seeks not only to explain these interstate differentials, but also to explain why California's unemployment rate has historically been above the national average.¹

A four-equation model, solved by two-stage least squares (2SLS), is developed to account for the joint determination of wages and unemployment. The unemployment rate equation subjected to empirical testing is a reduced form type. A comprehensive model dealing with all the structural equations which underlie this reduced form is beyond the scope of this work. Two equations, both dealing with labor force participation, are accounted for; they are abbreviated versions of equations generally found in the literature since it was necessary to keep the number of variables within computational range.

The results indicate that with respect to interstate unemployment differentials, only four variables (the change in construction employment, farm worker employment as a per cent of total employment, the change in manufacturing employment, and the proportion of college educated males) have statistical significance. For California, the major finding is that the climate

*Deputy Director and Chief, Division of Labor Statistics and Research, California Department of Industrial Relations.

¹Opinions are those of the author and do not necessarily reflect an official position of the Department of Industrial Relations. I am grateful to Wallace Hendricks, Michael Klima, George Strauss, Pauline Sweezey, Richard Tiller, Lloyd Ulman, and Alice Vandermeulen for helpful comments on an earlier draft. Most of the computer work for this research was supported by a grant of the Levi Strauss Foundation to the University of California at Berkeley.

and migration variables, posited as external forces that affect the state's labor market, raise this state's unemployment rate about 2 percentage points above the national rate.

TABLE 1
UNEMPLOYMENT RATES BY SELECTED STATES, 1970-1975

	1970	1971	1972	1973	1974	1975
Alabama	4.7	5.2	4.7	3.9	5.5	8.9
California	7.2	8.8	7.6	7.0	7.7	9.9
Connecticut	5.6	8.9	8.2	5.7	6.2	10.1
Florida	4.4	4.9	4.5	4.3	6.2	11.4
Georgia	4.1	3.9	4.1	3.9	5.0	9.6
Illinois	4.1	5.1	5.1	4.1	4.5	8.3
Indiana	5.0	5.7	4.5	4.2	5.9	8.8
Kentucky	5.0	5.5	4.8	4.4	4.5	7.7
Louisiana	6.6	7.0	6.1	6.0	6.7	8.3
Maryland	3.3	4.2	4.7	3.5	3.7	7.5
Massachusetts	4.6	6.6	6.4	6.7	7.2	12.5
Michigan	6.7	7.6	7.0	5.8	8.7	13.8
Minnesota	4.2	4.4	4.3	4.4	4.3	5.9
Missouri	3.3	4.9	4.2	3.7	4.5	7.3
New Jersey	4.6	5.7	5.8	5.6	6.0	10.2
New York	4.5	6.6	6.7	5.4	6.3	10.1
North Carolina	4.3	4.8	4.0	3.5	4.5	9.1
Ohio	5.4	6.5	5.5	4.3	5.0	8.5
Oklahoma	4.4	4.9	4.5	4.2	4.4	6.2
Oregon	6.2	6.6	5.7	5.3	7.5	10.2
Pennsylvania	4.5	5.4	5.4	4.8	5.1	8.9
South Carolina	5.0	5.3	4.2	3.7	4.5	11.1
Tennessee	4.8	5.0	3.6	3.0	3.9	8.5
Texas	4.4	4.9	4.5	3.9	4.3	6.1
Virginia	3.4	3.6	3.6	3.6	4.0	6.9
Washington	9.1	10.1	9.5	7.7	7.2	9.3
Wisconsin	3.9	4.5	4.2	4.1	4.6	7.0
27-state average	4.9	5.8	5.3	4.7	5.5	9.0
United States	4.9	5.9	5.6	4.9	5.6	8.5

Sources: *Employment and Training Report of the President*, 1976, p. 312.
Economic Report of the President, 1976, p. 196.

Interstate Unemployment Model

According to conventional economic theory, submarkets are interconnected by relative wages. If resources are fully employed in the total economy, then relative wages distribute labor among occupations, industries, and regions. Even with full employment economy-wide, some submarkets may suffer from less than full employment. If demand shifts vary among submarkets, some may be at equilibrium (i.e., demand equals supply at the real market wage), some may have more than frictional unemployment (excess supply), and some may have labor shortages (excess demand). Theoretically, labor market adjustments take place as workers and firms move between labor surplus and labor shortage areas, given that transportation and other overhead costs of moving can be absorbed.

If the total economy is not at full employment, relative wages can still allocate labor, albeit for a different reason. Given sufficient financial resources, unemployed workers may decide to move on the basis of improving the probability of finding a job, and firms may similarly move to areas of lower labor cost. Again, the locational decision in this case is assumed to be influenced by the wage structure. Hall has observed that, given a choice, the unemployed worker appears to be more likely to move to a high-wage, high-unemployment area rather than to a low-wage, low-unemployment area.² In this way, wages can influence the movement of unemployed workers.

The implication of the full-employment and less-than-full employment models is that interstate unemployment rates are functionally related to the interstate structure of real wages and to the migration of workers and firms among states. Hence, in the model tested here, unemployment rates and real wage rates are jointly determined.

To test the above theory, a real market wage would have to be available for each state, as conventional economic theory deals with perfect competition, which postulates that identical labor should tend to receive the same pay in similar industries, regardless of location, if all other job conditions are the same. As there is no wage variable available which takes account of compensating differences to leave only "pure" regional differentials, empirical testing in this paper must rely on a proxy variable, average hourly earnings in manufacturing. But, this proxy reflects conditions related to both supply and demand, nonpecuniary conditions, and any institutional differences that may exist among the states.

To take account of this problem in the real wage variable, the reduced form unemployment rate equation includes as explanatory variables those factors hypothesized as explaining the persistence in relative wages, since any compensating differences found may also underlie the unemployment rate structure. With this formulation, it becomes possible to identify which element(s), if any, of the real wage structure affect the unemployment rate structure. Consequently, the real wage structure equation is also empirically tested in order to assure that the substitution of the explanatory variables in the unemployment rate equation can be justified.³

The simultaneous equation model is:

$$(1) Y_1 = f(Y_2, Y_3, Y_4, Z, T, e_1)$$

$$(2) Y_2 = g(Y_3, Y_4, Z, X, T, e_2)$$

²Robert E. Hall, "Why Is the Unemployment Rate So High at Full Employment?", *Brookings Papers on Economic Activity*, 3: 1970, pp. 380-381.

³A simpler simultaneous equations model which uses only the real wage in the unemployment rate equation, rather than the determinants of real wages, shows that real wages and unemployment rates are related at the 1 per cent level of significance.

$$(3) Y_3 = h(Y_1, Y_2, G, T, e_3)$$

$$(4) Y_4 = j(Y_1, Y_2, K, T, e_4)$$

The Y 's are endogenous variables; T represents dummy variables for each year except 1975, which serves as the reference year; Z , X , G , and K are vectors of exogenous variables; and e 's are random error terms.

Endogenous variables are Y_1 , real wages, or average hourly earnings of manufacturing workers deflated by the BLS Intermediate Budget for a Four-person Family; Y_2 , unemployment rates; Y_3 , labor force participation rate of married women with husband present; and Y_4 , labor force participation rate of teenagers.

The vector Z represents climate, labor productivity, unionization, change in construction employment, change in manufacturing employment, production workers in manufacturing as a per cent of total manufacturing employment, seasonal variation, percentage of males 25 years old and over with four or more years of college, and a dummy variable for the presence or absence of state minimum wage laws.

The vector X represents farm workers as a per cent of total employment and weighted by the per cent of family workers on farms, net migration rate of blacks, net migration rate of whites, public assistance expenditures, business taxes, and unemployment insurance benefits purged of the money wage effect.

Vector G represents two variables: (1) the labor supply variable, women 20 years and older as a per cent of both sexes 20 years old and over in 1975, and (2) non-durable goods manufacturing as a percentage of total nonagricultural employment in 1970. This latter variable is included to account for labor demand differences among states and is based on an empirical observation made by the author.

K is the per cent of 16-19 year olds in the total population in 1975, or the supply variable in Equation 4. No demand variable enters Equation 4 as it is assumed that demand for these basically entry workers is similar across the states.⁴

The equations tested are based on a pooled sample of 27 states over the six years, 1970-1975. The sample is restricted to those states which in 1974 had unemployment estimates based on the Current Population Survey (CPS). In 1974, this group of states accounted for 87 per cent of the nation's civilian labor force and 89 per cent of the nation's unemployed. Using the CPS states avoids problems of interpretation that could arise from measurement differences.

Because state data for all variables were not available for each year, some data are for only a specified time period, which is noted in Table 2. These variables are thus constants in any given state either over the entire period, or for some subset of the period.

The Real Wage Structure

The real wage structural equation is estimated first in order to provide the rationale for explicitly including the explanatory variables in this equation in the unemployment rate equation. By explicitly including these variables, the effects, if any, of the net advantages (disadvantages)

⁴See Table 2 for more complete descriptions of these variables. Full descriptions and sources of these variables are available from the author on request.

of occupations, industrial structure, compensating differences, institutional factors, nonpecuniary conditions, relative shifts in labor demand, responsiveness of secondary workers to labor market conditions, and differences in capital-labor ratios may be distinguished.⁵

Following is the rationale for the development of Equation 1, the predicted effects of each of the variables on real wages, and the 2SLS regression results (see Table 2).

The *unemployment rate* (with which wages are jointly determined) should be positively related to real wages if there is wage flexibility. As seen in Table 2, this hypothesis is rejected.

According to Adam Smith, differences in wages may be inherent in the employment itself. Equation 1 accounts for three of his five compensating differences: *production workers as a per cent of total manufacturing employment* is used as a proxy for relating a state's occupational wage structure to the agreeableness or disagreeableness of a job. Production worker jobs are probably more disagreeable than white-collar jobs as well as being more physically demanding. Hence, this factor should be positively related to wages. This hypothesis receives strong support. *Seasonal variation in employment* should be positively related to wages because irregularity of employment should indicate a higher wage. This hypothesis is not supported, although the sign is correct. The variable related to the expense of training is *the percentage of college-educated males in a state*. The more the state's employed members are in occupations requiring extensive periods of training, i.e., professional and technical occupations, the higher should be the

⁵There is a large body of literature dealing with regional wage differences. Generally, see Gerald W. Scully, "Interstate Wage Differentials: A Cross Section Analysis," *American Economic Review*, LIX (December, 1969), 757-773. This article, most analogous to the interstate wage analysis in this study, contains a summary of much literature dealing with regional wage differentials. Articles not covered in the Scully paper include: Lowell E. Gallaway, Richard K. Veder, and Gene L. Chapin, "The Impact of Geographic Mobility on Regional Wage Differentials: A Test of the Steady-State-Equilibrium Hypothesis," 1970 *Proceedings* of the Business and Economic Statistics Section, American Statistical Association; Victor Fuchs, "Differentials in Hourly Earnings by Region and City Size, 1959," Occasional Paper No. 101, National Bureau of Economic Research (New York: 1967); F. W. Bell, "The Relation of the Region, Industrial Mix, and Production Functions to Metropolitan Wage Levels," *Review of Economics and Statistics*, XLIX (August, 1967), 368-374; M. A. Zaidi, "Structural Unemployment, Labor Market Efficiency and the Intra-Factor Allocation Mechanism in the United States and Canada," *Southern Economic Journal*, XXXV (January, 1969), 205-213 and comments on this paper in the *Southern Economic Journal*, XXXIX (October, 1972), 307-310; L. E. Gallaway, "Labor Mobility, Resource Allocation, and Structural Unemployment," *American Economic Review*, LIII (September, 1963), 698-701; and R. L. Raimon, "Interstate Migration and Wage Theory," *Review of Economics and Statistics*, XLIV (November, 1962), 428-438. Fairly comprehensive discussions on regional wage differentials appear in Bevars D. Mabry, *Economics of Manpower and the Labor Market* (New York and London: Intext Educational Publishers, 1973), Chap. 15, and in Sylvia Ostry and Mahmood A. Zaidi, *Labour Economics in Canada* (2d ed.; Toronto, Canada: Macmillan, 1972), Chap. XII. I know of no study dealing with geographic persistence in unemployment rates except the Hall paper, *op. cit.* Hall devotes one section of his paper to variations in unemployment among 12 cities.

TABLE 2
REAL WAGE AND UNEMPLOYMENT RATE REGRESSION RESULTS FOR 27 STATES, 1970-1975
(t-statistics in parentheses^a)

Explanatory variables	Dependent variable	
	Real wage	Unemployment rate
Constant	2.612* (2.398)	3.941 (0.219)
1975	.000	.000
1874 ^b	-.410** (-3.123)	-1.946** (-5.351)
1873 ^b	-.896** (-5.042)	-1.634** (-2.657)
1872 ^b	-1.184** (-7.572)	-1.145* (-2.136)
1871 ^b	-1.393** (-11.612)	-1.503** (-4.713)
1870 ^b	-1.480** (-10.216)	-2.725** (-8.921)
Farm workers as a per cent of total employment weighted by per cent of family workers on farms, 1974		-.407** (-2.912)
Per cent net migration of blacks as per cent of state's 1965 black population, 1965-1970		.145 (.654)
Per cent net migration of whites as per cent of state's 1965 white population, 1965-1970		-.033 (-.215)
Total public assistance expenditures per capita, 1970 through 1973 (1973 data applied to 1974 and 1975)		.002 (.398)
Business taxes as per cent of total labor and proprietors' income (proxy for business income), each year		.368 (.581)
Average weekly unemployment insurance benefits purged of money wage effect, each year		.011 (.379)
Climate—mean number of days minimum temperature 32°F or less, period of record ending in 1972	-.001 (-.048)	-.016 (-1.347)
Labor productivity—value added per manhour in manufacturing, 1972	.104** (3.844)	.178 (.858)
Labor union membership as per cent of total nonagricultural employment, 1970, 1972, 1974	.012* (2.356)	.006 (.116)
Annual percentage change in contract construction employment, each year	.016** (2.771)	-.085** (-5.008)
Annual percentage change in manufacturing	-.007 (-.611)	-.063† (-1.824)
Production workers in manufacturing as per cent of total manufacturing employment, 1972	.028** (3.330)	.021 (.264)
Seasonal variation in nonagricultural employment, each year	.012 (.686)	.014 (.094)
Percentage of males 25 years old and over with four or more years of college, 1970	-.023 (-1.576)	-.254† (-1.640)

TABLE 2 (Continued)

Explanatory variables	Dependent variable	
	Real wage	Unemployment rate
Teenage (16-19 years) labor force participation rate, 1974	.028** (3.805)	.058 (.300)
Married women, with husband present, labor force participation rate, 1970	-.076** (-4.681)	.010 (.052)
Minimum wage state (dummy variable), 1974 ^c	.199** (2.662)	-.226 (-.510)
Unemployment rate, each year	.034 (.853)	
R ²	.864	.846
Standard error of estimate	.284	.866

^a t-statistics are based on standard errors in the 2SLS procedure which have been adjusted and are asymptotically correct. See G. S. Maddala, *Econometrics* (New York: McGraw-Hill, 1977), p. 239, for adjustment procedure.

^b t-values measure significance relative to 1975, the missing year.

^c t-value measures significance relative to states without minimum wage laws.

Significance levels: **1 per cent; *5 per cent; †10 per cent.

wage to compensate for the years of training required.⁶ The coefficient for this variable, while negative, has no statistical significance; thus the hypothesis must be rejected.

The responsiveness of the secondary labor force in each state to prevailing labor market conditions could affect wage differences among states, as *labor force participation rates for both teenagers and married women with husband present* affect the position of a state's labor supply curve. Given a stable demand curve, the influence of these labor force participation rates should be negative on wages, i.e., the relative wage should be lower the more labor supply is enlarged, and vice versa. As noted earlier, these two variables are endogenous as they both affect and are affected by unemployment and wages.

As seen in Table 2, the hypothesis is supported only for married women. The negative coefficient is statistically significant at the 1 per cent level. This finding suggests that these married women are in the labor force to supplement family income and increase the family's purchasing power. In those states with lower real wages, the economic motivation to enhance the family purchasing power should be greater than in those states with higher real wages. This evidence is consistent with other survey findings, as well as with the regression results for Equation 3.⁷ When the labor force par-

⁶ Although this variable is restricted to men, later research showed this was not necessary as the proportion of all persons 25 years and over who have four or more years of college is almost perfectly correlated with the male percentage.

⁷ See James A. Sweet, *Women in the Labor Force* (New York and London: Seminar Press, 1973).

participation rate of married women is taken as the dependent variable, it is negatively related to real wages at a high significance level, holding constant both the labor supply and demand variables used in the model. This finding is also consistent with recent casual reports that double-digit inflation pushed more married women into the labor market in an effort to sustain family purchasing power. Such evidence lends support to a purchasing power theory of labor force participation for married women.

The hypothesis is rejected for the labor force participation rate of teenagers. Here the variable is positively and significantly related to real wages. The expected negative relationship was posited on the assumption that teenage workers are part of the secondary labor force. (Secondary workers in this context refer to those whose job attachment is low because career advancement on the job is not of interest; hence, such workers move in and out of the labor market and when in it exhibit high turnover.) However, in the present case, the labor force participation of teenagers is actually higher the higher the real wage level, all else held constant.

Why this is so remains a matter of conjecture. One explanation may be that market opportunities appear to be better for teenagers in high-wage states than in low-wage states; another may be that teenagers have a higher reservation price than has been believed and will participate to a greater degree in the market the higher the wages.

Climate in the real wage equation accounts for the important nonpecuniary consideration. A positive sign is expected the colder the climate, i.e., the larger the number of freezing days, the higher should be the real wage to compensate for the discomfort. The regression results do not support this hypothesis.

Differentials in wages may also arise from differences in the capital-labor ratios which may yield different values of marginal product schedules.⁸ This

pp. 5-31. The 2SLS regression results, excluding the time dummies and constant, for Equations 3 and 4 of the model are:

Variable	Equation number	
	3	4
	(Regression coefficients and t-statistic)	
Unemployment rate, all years	.158 (1.088)	— .222 (— .604)
Real wage, all years	—4.413 (—7.793)	1.002 (1.031)
Women 20 years and older as a per cent of both sexes 20 years old and over, 1975	—1.978 (—8.229)	
Nondurable goods manufacturing as a per cent of total nonagricultural employment, 1970	.317 (7.294)	
16-19 year olds as a per cent of total population, 1975		1.151 (1.677)
R ²	.675	.038.

⁸Lowell E. Gallaway, "The North-South Differential," *Review of Economics and Statistics*, XLV (August, 1963), 269-270.

factor is accounted for by *value added per manhour in manufacturing*, or *average value productivity*, for production workers in manufacturing. On the assumption that average and marginal productivity are proportional, this variable is expected to be positively related to wages: the higher the capital-labor ratio, the more workers should produce, and so the higher the wages received. This hypothesis is strongly supported.

The *rate of unionization* is expected to have a positive influence on relative wages as it is the business of unions to improve wages and working conditions for their members. This hypothesis is also supported.

Relative shifts in labor demand, reflecting growth and contraction of industries, need not be similar among the states. These differences in variation of labor demand should, given stable labor supply and holding all else constant, account for differences in relative wages. *Percentage changes in the employment of the two goods producing sectors, construction and manufacturing*, are used to capture this effect, thus distinguishing states with respect to the rate of economic growth.⁹ These two sectors were selected a priori because they are expected to have larger secondary, or multiplier, effects on the labor market than developments in the service-oriented sectors.

In the regression results, the coefficient for the manufacturing employment variable has no statistical significance. In contrast, the construction employment-change variable is positively and significantly related to relative wages and suggests that changes in construction employment affect relative wages as predicted by conventional economic theory.

The final wage determinant is the presence or absence of a *state minimum wage law*. A dummy variable of one is used if a state has such a law, and zero otherwise. Logically, states with laws which supplement the Federal Fair Labor Standards Act should have higher wages than those without such laws. This hypothesis is also supported.

To summarize, most hypotheses regarding interstate real wage differentials receive support in the estimated 2SLS equation,¹⁰ suggesting that the persistence of relative wages can be explained within a framework that takes account of wage theory in combination with relevant institutional forces. Consequently, these same compensating differences may help explain the interstate unemployment rate structure. It is of interest to note that the highly significant results explaining the interstate wage structure have been achieved by stressing structural differences in labor markets

⁹See Leonard F. Wheat, *Regional Growth and Industrial Location* (Lexington, Mass.: Lexington Books, 1973), who uses manufacturing employment to measure regional economic growth.

¹⁰Although the explained variance is 86 per cent, it should be noted that if the time dummies are excluded, R^2 drops to 48 per cent.

with respect to industrial and occupational attributes, employment changes in construction, and institutional underpinnings. These results support Hanushek's insights regarding the failure of human capital models to explain the variation in incomes.¹¹ This evidence also supports the hypothesis that the mobility of capital into the South and labor from it have not been of sufficient magnitude to adjust wage differentials.¹²

The Unemployment Rate Structure

Farm workers as a per cent of total employment weighted by the per cent of family workers on farms enters the unemployment rate equation as a result of the empirical observation that farm worker unemployment rates have historically been lower than the total national rate.¹³ In part at least this is due to the fact that about 75 per cent of farm workers nationally are family workers,¹⁴ who are likely to appear as employed in the Census count but unlikely to be included in the unemployment count. Since the farm worker unemployment rate is biased downward, states with a larger/smaller percentage of farm workers to total employment should therefore have a lower/higher unemployment rate than the average, and the regression results indeed support this hypothesis.

Net migration rates of blacks and whites for the period 1965-1970 are the empirical variables used to account for the effect of labor mobility on unemployment rates. Separate migration rates are used because previous studies show that the two groups respond differently to costs and benefits of migration.¹⁵ Use of past net migration rates both recognizes that lags take place in labor market adjustments and also eliminates the possibility of simultaneous equations bias. It should be noted that while such migration data are employed in this study as a proxy for interstate mobility by mem-

¹¹Eric A. Hanushek, "Regional Differences in the Structure of Earnings," *Review of Economics and Statistics*, LV (May, 1973), 204-213.

¹²Mabry reaches this conclusion after reviewing evidence on regional wage differentials. *Op. cit.*, p. 418.

¹³In 1975, for example, the farm worker unemployment rate was 3.5 per cent, while the national rate was 8.5 per cent. *Employment and Training Report of the President*, 1976, p. 244.

¹⁴Bureau of Labor Statistics, *Handbook of Labor Statistics*, 1976, Bulletin 1905, p. 100.

¹⁵M. J. Greenwood and P. J. Gormely, "A Comparison of the Determinants of White and Nonwhite Interstate Migration," *Demography*, VIII (February, 1971), 141-155. Ben-chieh Liu, "Differential Net Migration Rates and the Quality of Life," *Review of Economics and Statistics*, LVII (August, 1975), 329-337. Liu develops a quality of life (QOL) index which is regressed on net migration rates of all workers and nonwhite workers. QOL is an extremely significant variable affecting the nonwhite net migration rate, but has a weaker influence on the white net migration rate. One of the components of QOL is individual status, which reflects maximum development of individual capabilities, independence, and opportunities for self-support. This variable is a significant determinant of the total net migration rate, but it is not significant in the nonwhite net migration rate. It should also be noted that published migration statistics for this period are not available, to my knowledge, for the Spanish-origin population, an important ethnic group in California.

bers of the labor force, the net migration figures reported here are for the population as a whole, including those not in the labor force.¹⁶

In this analysis, it is posited that whites migrate from high unemployment to low unemployment states, in which case their mobility would serve as an equilibrating mechanism. This hypothesis rests on the proposition that if jobs are available elsewhere, migrating whites would be more likely to quickly find them in the new home state. In contrast to their nonwhite counterparts, white interstate migrants tend to be older, better educated, and to have higher incomes.¹⁷ Furthermore, there is an observed tendency for nonwhite migration flows to contain larger percentages of unemployed persons than white flows,¹⁸ indicating that whites are more likely to move from one job to another and thus likely to have been absorbed into a given state's labor market during the study period. This hypothesis—that the white net migration rate for the 1965-1970 period would have had little effect on interstate employment rate differentials in the 1970-1975 period—is supported by the regression results.

Somewhat different forces influence black migration. Because of labor market discrimination, technological change in agriculture, and other reasons, blacks have continued to leave the South in search of opportunities in the urban states, states with high wages but also with high unemployment. Median income data for 1970, for husband and wife families, provide some evidence for the assumption that black migrants from the South were in the lower skills levels.¹⁹ Although this black migration was from states with low unemployment rates, many of which were in the less urbanized South, to states with high unemployment rates, it must be remembered that the low official unemployment rates ignore the substantial underemployment (or disguised unemployment) existing in rural areas.²⁰

Several factors can be offered to explain black migration to high unemployment areas. The dual labor market theory, that some members of the labor force have difficulty in getting into the mainstream of the labor market and its attendant career ladders,²¹ suggests that blacks would have an impetus

¹⁶Raimon has noted the existence of this conceptual problem; however, his evidence suggests that the results are probably not affected. See Raimon, *op. cit.*, p. 434.

¹⁷Greenwood and Gormely, *op. cit.*

¹⁸M. J. Greenwood, "Research on Internal Migration in the United States: A Survey," *Journal of Economic Literature*, XIII (June, 1975), 421.

¹⁹U.S. Department of Commerce, Social and Economic Statistics Administration, Bureau of the Census, *The Social and Economic Status of the Black Population in the United States, 1974*, Special Studies, Series P-23, No. 54, July, 1975, p. 38. In 1970, median income of black, husband only earners in the South was \$4,370 a year, while that for white, husband only earners was \$8,520, an earnings ratio which must certainly reflect differences in occupational levels.

²⁰See M. J. Greenwood, "An Analysis of the Determinants of Geographic Labor Mobility in the United States," *Review of Economics and Statistics*, LI (May, 1969), 192-193.

²¹See Peter B. Doeringer and Michael J. Piore, *Internal Labor Markets and Manpower Analysis* (Lexington, Mass.: Heath, 1971). See also, Glen C. Cain, "The Challenge of Segmented Labor Market Theo-

to leave the South if they are unable to find attractive jobs there.²² As technological changes diminished the number of agricultural jobs in the South, blacks could have assumed that they would be blocked from mainstream occupations in nonagricultural industries and therefore risked movement to regions where they could be accepted into the occupational mainstream. If they had inadequate skills to enter this job market or if discriminatory practices continued in the industrial-urban states, then this migration would amount to movement from underemployment to unemployment. The queue theory of the low-income labor market²³ offers another means of explanation. Migrating blacks could have been on the bottom of the queue in the late sixties, but then could have been recruited because of an increased labor demand; when the demand decreased, they would have been the first laid off. This queue theory is supported by Greenwood's finding that increased white unemployment results in a more than proportionate rise in nonwhite unemployment.²⁴

Because of such factors, the black net migration rate is expected to be positively related to the unemployment rate structure. However, although the regression coefficient is positive, it lacks statistical significance.

Public assistance expenditure and business taxes represent institutional variables which are included in the equation because these costs could push employers from high-tax to low-tax states, and thus increase unemployment in high-tax states where jobs are lost. High welfare payments are also perceived as having a positive effect on immigration and an adverse effect on outmigration. The variable used for business taxes is a construct computed as follows: taxes specified as having an initial impact on business were added for each state for each year, and this total was standardized by total labor and proprietors' income for that year.²⁵ Total public assistance expendi-

ties to Orthodox Theory: A Survey," *Journal of Economic Literature*, XIV (December, 1976), 1215-1257, for an explanation of this theory and the theories of noncompeting groups and queues.

²²See R. A. Gordon, "Comments and Discussion," *Brookings Papers on Economic Activity*, 3: 1970, p. 405.

²³See Melvin W. Reder, "Wage Structure and Structural Unemployment," *Review of Economic Studies* XXXI (October, 1964), 309-322. See also Lester C. Thurow and Robert E. B. Lucas, *The American Distribution of Income: A Structural Problem*, Joint Economic Committee, 92d Cong., 2d Sess., 1972.

²⁴M. J. Greenwood, "Research on Internal Migration....," p. 421. The queue theory also receives support in the rigorous study of employment opportunities for New York City's low-income population by Ruth Fabricant Lowell. See *The Labor Market in New York City: A Study of Jobs and Low-Income Area Workers in 1975*, City of New York, Department of Social Services, Division of Policy Research, May 1975, 193 pp. She also found that discrimination is an important determinant of one's position along the queue.

²⁵The list of taxes thought to have an initial impact on business was suggested by the group of taxes appearing in a publication of the Advisory Commission on Intergovernmental Relations, *State-Local Finance: Significant Features and Suggested Legislation* (M-74), 1972 edition. "Total labor and proprietors' income" was used to standardize the interstate tax aggregates because of the lack of state data on business income. This standardization variable was suggested by Edward M. Gramlich.

tures per capita is used as the measure of welfare spent. This reasoning suggests that the coefficients for these two variables should be positive again, however, although the signs are correct, statistical significance is lacking.

It has been asserted that the higher the level of *unemployment insurance benefits*, the higher should be the unemployment rate because high benefits reduce the incentive to find another job quickly, or they reduce the incentive to outmigrate to a better labor market, or they increase the incentive to migrate to a high-benefit state.²⁶ Since benefits are directly tied to average weekly earnings accrued over a recent period, the effect of unemployment insurance benefits must continue to have an effect on unemployment rates after being purged of the influence of average wages, which are already taken into account in the model. Consequently, the unemployment insurance variable in this model is the error term resulting from regressing average weekly unemployment insurance benefits on average hourly earnings in manufacturing. These error terms, or residuals, thus embody different state policies towards paying these benefits. In other words, those states with more liberal insurance benefit policies would have larger than average residuals. The regression coefficient for this variable does have a positive sign in the regression equation, but it is not statistically significant. Thus, the hypothesis that different levels of insurance benefits, once purged of the wage effect, have an effect on interstate unemployment differentials is not supported.

Alfred Marshall noted that peculiarities indigenous to the labor market, as contrasted with the commodity market, slow the adjustment of supply to demand changes. One of these peculiarities is that the seller of labor must deliver himself to the work place to render services, a fact which has implications for the conditions of a job. When evaluating a job, the worker may attach a great deal of weight to working (and living) conditions, as well as to the pay.²⁷

Climate here is used to denote nonpecuniary advantages (disadvantages), with an empirical value fixed by the number of days of freezing or lower temperatures. Conventional wisdom suggests California's mild climate has served to induce net immigration and to keep sufficient numbers of unemployed workers from leaving, even when unemployment is high relative to other states. If this hypothesis is correct, we should expect that mild climate

²⁶See, for example, Martin S. Feldstein, *Lowering the Permanent Rate of Unemployment*, a study prepared for the use of the Joint Economic Committee, 93rd Cong., 1st Sess., 1973, p. 48, for a closely corresponding view.

²⁷Alfred Marshall, *Principles of Economics* (8th ed.; New York: Macmillan, 1948), Bk. VI, Chaps. iv and v, pp. 559-579. See also Liu, *op. cit.*

states, such as California, would have a higher than average unemployment rate, all else held constant.

It could also be argued that cold weather states should have higher unemployment rates because harsh winters would have a negative influence on outdoor activities and so induce relatively more unemployment than in states where outdoor activities take place year round. This influence would operate on the labor demand curve. If this labor demand effect dominates the supply effect noted above, then we should observe a positive coefficient on the climate variable because the more days of cold weather in a state, the higher the unemployment rate.

As there are two competing hypotheses regarding the effect of climate, it becomes an empirical question as to which effect dominates. The regression results are consistent with the supply curve hypothesis, although the coefficient falls short of statistical significance.

For many states, the exclusion of this climate variable had little if any impact on the residuals. For California, however, exclusion increased the residual and hence tends to confirm the conventional wisdom that workers prefer good climate to bad and, when necessary, are willing to pay the price of unemployment. However, it may be that California's geographic distance from other industrial centers makes relocation expensive for the unemployed, thereby holding workers in the state even though employment is preferred to pleasant living conditions.

Because *labor productivity* is strongly related to relative wages inasmuch as wages are an important element of value added,²⁸ the relationship between this variable and unemployment rates should be positive. Although the sign is correct, the coefficient again does not reach significance.

There does not seem to be any *a priori* reason for a *unionization* effect on the unemployment rate structure, a belief which Wheat's quantitative study of regional growth supports.²⁹ His analysis implies that unionization is the final effect of a causal chain that involves intervening variables between industrialization and unionization. By analogy, unionization may be rejected as having an impact on the unemployment rate structure. This reasoning is supported in the regression results.

Changes in construction and manufacturing employment, as employment-change variables, should be negatively related to unemployment.³⁰ Given

²⁸The simple correlation coefficient between value added per manhour in manufacturing and average hourly earnings based on related data from the 1972 *Census of Manufactures* is .79.

²⁹Wheat, *op. cit.*, pp. 194-195.

³⁰Given that the period under study was one marked by changes in the size and frequency of defense contract awards, the potential effects of those changes on manufacturing employment were also examined. In annual regressions for 1970-1971 (including a year's lead to account for lag), the rate of change in deflated awards did have an effect on manufacturing employment; but this is an isolated response

fixed supply, increased employment should reduce unemployment and vice versa. In fact, the construction employment-change variable is significantly negative at the 1 per cent level while that for manufacturing is significantly negative at the 10 per cent level. (This is not surprising, of course. Contract construction uses a host of intermediate goods in production, involving practically every sector in manufacturing; the nature of this industry's product demand is such that it impacts heavily on local, or at least not too distant, labor markets; and construction activity directly affects many sales outlets, as well as the finance, insurance, and real estate industries.)

Production workers as a per cent of total manufacturing should be positively related to unemployment rates because these workers are more frequently subject to layoff than their white-collar counterparts. Although this coefficient has a positive sign, the result is not of statistical significance.

Relative seasonal variation should be positively related to unemployment by definition. Seasonality implies recurrent swings in employment needs so that workers are more prone to periodic layoffs.³¹ This variable does not affect interstate unemployment differentials according to the 2SLS regression results, although the sign is positive.

Per cent of males 25 years old and over with four or more years of college should have a negative effect on unemployment rates. This is consistent with the theory that better educated persons embody much capital investment in themselves. Possessing skills and training not easily replaced, these workers fill jobs which are at the top of the occupational spectrum, positions characterized by stability, career advancement potential, and high wages. As expected, the coefficient is negative and statistically significant at the 10 per cent level.

Labor force participation rates of teenagers and married women with husband present, considered as the secondary labor force, are expected to be negatively related to the unemployment rate structure.³² This reasoning is based on the "discouraged worker" hypothesis which states that these workers adjust their entry into and exits from the labor market on the basis of job availability. This expectation is not supported in the regressions as

to the fact that during that year only, defense contracts declined across all states, with a 22 per cent average reduction. Additional tests (not reported here) indicate that including the rate of change in contract awards has virtually no effect either on other estimators or on the residuals. In fact, the variable had a positive coefficient. In short, it appears that these rates of change, when pooled over the six years, basically represent a series of random events.

³¹Relative seasonal variation was computed by taking the difference between the lowest and highest employment figures and dividing that difference by annual average nonagricultural employment. This variable is not precisely a seasonal variation figure, however, because the ratio may be affected by heavy cutbacks resulting from cyclical downturn, or, conversely, new recruiting resulting from a cyclical upturn.

³²See footnote 7 for regression results.

neither variable has statistical significance, suggesting that after taking account of structural labor market conditions and demand shifts, these workers' responses to labor market opportunities do not vary sufficiently among the states to cause differences in unemployment rates.

Finally, the expectation that states with *minimum wage laws* would have higher unemployment rates than those states without such laws received no support in the regression results.

Discussion

A four-equation system was used to compute the unemployment rate structural equation. In this model, apart from the time dummies,³³ the 2SLS procedure yielded only four statistically significant variables: the change in construction employment, farm worker employment as a per cent of total employment, the change in manufacturing employment, and the proportion of college educated males (a proxy for the state's professional and technical work force).

However, with respect to why an unemployment rate in any single state may exceed the national average, other variables besides these four could have decisive impact. The climate variable, for example, reduced California's residual, but had little effect on the residuals of many other states.

An analysis of the residuals points out the differences across states (see Table 3). For each cross section within each year the expected value of the error terms is zero. Analysis of the time-to-time residual distribution for each state, however, shows that in only 14 states is the expected value of the residuals zero over the six years. In the remaining 13 states, the expected value of the residuals is significantly different from zero. The time-to-time residuals for each state were also examined for serial correlation. The test for autocorrelation was conducted by examining the sign pattern of the residuals in a contingency table,³⁴ which showed autocorrelation present in 7 states (according to the chi-square value) at the 5 per cent level of significance. In some states, therefore, two assumptions of the linear model are violated, namely, that the expected value of the residuals is zero and the errors are not serially dependent. Obviously, further research is called for. However, it is important to note that it may be difficult to find a gen-

³³As noted, the cross-section, time-series model here assumes that time is a fixed variate and includes dummy variables for each year. The 2SLS unemployment rate equation computed without time dummies produced an R^2 of .79. The regression coefficients of these dummy variables relating to each year are significant relative to 1975 and show the severity of the 1975 recession. I interpret these results as accounting for the effect of national economic developments that cut across all labor markets over these years.

³⁴See G. S. Maddala, *Econometrics* (New York: McGraw-Hill, 1977), p. 88, for this test and the original reference on which it is based.

TABLE 3
RESIDUALS FROM 2SLS UNEMPLOYMENT RATE EQUATION

State	1970	1971	1972	1973	1974	1975
Alabama	-.3	-.2	-.3	.0	.9	.7
California	-.1	.4	-.1	.2	-.2	-1.1
Connecticut	1.2	2.2	2.1	.6	.4	.5
Florida	-.6	-1.3	-.1	.4	-.6	-.4
Georgia	-.7	-.9	.1	-.7	-.8	-.1
Illinois	-.6	-1.4	.1	-.6	-.8	.5
Indiana	-.2	-.3	-.4	.1	.7	.0
Kentucky	1.2	1.5	1.2	.6	.0	-.2
Louisiana	.1	.2	-.2	-.4	.2	-.6
Maryland	-.4	-.8	-.5	-.7	-1.2	-.7
Massachusetts	-1.2	-.5	-.4	.3	.0	2.1
Michigan	-.7	.5	.1	-.6	1.3	2.4
Minnesota	.1	-.8	-.8	.7	-.1	-1.4
Missouri	-.2	.4	-.2	.2	.3	.2
New Jersey	.2	-.3	.2	.5	.9	.4
New York	-.6	.2	-.2	-.4	-.3	.0
North Carolina	.4	.2	.0	-.9	-.3	1.4
Ohio	.1	.4	.2	-.2	-.4	-.4
Oklahoma	2.1	1.1	1.0	2.0	1.0	-.5
Oregon	-.6	.4	.0	-.6	.9	.3
Pennsylvania	-.9	-1.1	-.7	-.9	-.6	-.2
South Carolina	1.2	.3	-.2	.0	.0	1.8
Tennessee	.5	.6	-.4	-.8	-.7	.0
Texas	-.2	-.9	-.6	-.4	-.1	-1.8
Virginia	.2	-.5	.2	.7	.2	-1.3
Washington	1.0	1.7	1.3	1.2	.1	-.2
Wisconsin	-1.2	-1.4	-1.3	-.3	-.6	-1.7

eralized correction factor to account for the autocorrelation. For example, the pattern of residuals in 2 of the 7 states, Connecticut and Washington, reflects difficulties in absorbing heavy cutbacks in defense production relative to their narrowly based economies. California also suffered severe defense contract cutbacks between 1969 and 1971. However, because of its large and diverse labor market, this shock was cushioned in California, although the largest positive residual, .4, does occur in 1971. In Maryland, another of the 7 states, the predicted unemployment rate is consistently greater than the actual rate, possibly because of its unique labor market; many federal government workers live there, but work in Washington, D.C. The CPS, however, counts the employed and unemployed by place of residence. It is probably a safe conjecture that the unemployment rate of these federal government workers is extremely low, making Maryland's actual unemployment rate lower than that predicted by the model.³⁵ In Oklahoma the net total migration rate doubled from the 1965-1970 to 1970-1975 peri-

³⁵Indirect support exists for this analysis. The 1976 revision of the Washington, D.C., unemployment rate to achieve conformity with CPS labor force definitions raised this city's unemployment rate by 1.7 percentage points. See U.S. Department of Labor, Bureau of Labor Statistics, *Estimating State and Local Unemployment: Problems and Perspectives*, Report 500, 1977.

od with job development apparently not keeping pace. These examples suggest the difficulty in generalizing about autocorrelation.

Predicting Unemployment in California

One purpose of this research was to identify why the California unemployment rate has generally been higher than the national unemployment rate. As Table 4 indicates, the model predicts the California unemployment rate fairly closely, and the residuals from time-to-time for this state have an expected value of zero and are not autocorrelated.

TABLE 4
CALIFORNIA UNEMPLOYMENT RATE

	Actual	Predicted	Residual
1970	7.2	7.3	-.1
1971	8.8	8.4	.4
1972	7.6	7.7	-.1
1973	7.0	6.8	.2
1974	7.7	7.9	-.2
1975	9.9	11.0	-1.1

The basic variables in the model can be separated into (1) forces exogenous to a state's labor market (climate and net migration rates); (2) structural differences in the farm work force (the farm worker employment per cent weighted by the unpaid family worker per cent) and the institutional variables; and (3) internal labor market factors (determinants of the wage structure). We can then ask what the California unemployment rate would be if the state resembled the 27-state average with respect to external forces over which state policy or labor market operations have no control, i.e., climate and net migration rates. This is analogous to comparison with the nation as these 27 states in 1974 had 89 per cent of the nation's unemployed. Table 5 addresses this question.

In row 2 of Table 5, the parameters for climate and net migration rates from the 2SLS results are applied both to the California and 27-state average values of these variables. These results are subtracted and the difference is 2.1 per cent more for California. In other words, this row shows that if the climate and net migration rate variables for California were to correspond to the 27-state averages for these values, then the California unemployment rate would, on the average, be 2.1 percentage points lower than it actually was over the six-year period studied here. This figure is also used for each year because annual data are not available for these variables. Obviously, net migration rates do differ year to year. Hence, using 2.1 percentage points for the specific years must be considered an approximation.

TABLE 5
DIFFERENTIAL BETWEEN CALIFORNIA AND NATIONAL UNEMPLOYMENT RATES

	1970	1971	1972	1973	1974	1975	Six-year average	1976	1977
1. Actual differential between California and national unemployment rate	2.3	2.9	2.0	2.1	2.1	1.4	2.1	1.5	1.2
2. Differential attributed to differences in climate and net migration rates between California and 27 states	2.1	2.1	2.1	2.1	2.1	2.1	2.1	2.1	2.1
3. Differential attributed to variation between California and national percentage changes in construction and manu- facturing employment	.4	.5	-.1	-.4	.0	-.3	.0	-.3	-.8
4. Predicted differential, row 2 plus row 3	2.5	2.6	2.0	1.7	2.1	1.8	2.1	1.8	1.3
5. Prediction error, row 1 minus row 4	-.2	.3	.0	.4	.0	-.4	.0	-.3	-.1

As seen in row 1 of Table 5, the actual differential between the California unemployment rate and that of the nation varies from year to year. The results of the 2SLS regression procedure suggest a rule-of-thumb measure that can be used to explain the year-to-year variation. Recall that both employment-change regression coefficients have statistical significance in the 2SLS procedure. Hence, these dynamic variables contribute to interstate differences in the unemployment rate structure, or implicitly to the difference between any state's unemployment rate and that of the nation. This information is used to derive data in row 3 as follows: for each year, the difference between the annual rates of change for both construction and manufacturing employment for California and the nation was multiplied by the respective regression coefficient and the results added.

As row 3 shows, the differential from this source of variation was positive in 1970 and 1971. In these years California did not do as well as the nation with respect to year-to-year changes in construction and manufacturing employment. For years where this number is negative, California's industries performed relatively better than those in the nation at large. Adding the differentials in rows 2 and 3 gives the predicted differential in row 4. The magnitude of the error between the actual differential (row 1) and the predicted differential (row 4) is shown in row 5.

The rule-of-thumb measure described above is also applied to 1976 and 1977, which are outside of the data set in this paper.

In 1976, the actual differential was 1.5 percentage points. Between 1975 and 1976, however, California's employment growth in both construction and manufacturing exceeded that of the nation. As a consequence, these two factors reduced the "overhead" differential of 2.1 percentage points to 1.8 percentage points. Although the predicted differential exceeds the actual one by .3 percentage point, the direction of the predicted error is correct, i.e., it is less than the "overhead" rate, because of the better performance, relative to that for the nation, in both construction and manufacturing employment.

In 1977, the differential between California's unemployment rate and that of the United States narrowed to 1.2 percentage points. This reflected the impact of the percentage increase from 1976 in California's construction employment, which was more than twice that for the nation as a whole, as well as an increase in manufacturing that was almost one and a half times the national rate. Together, these two factors cut .8 percentage points from the "overhead" differential. The predicted differential in 1977 was thus reduced to 1.3 percentage points, or only .1 more than the actual differential in 1977.

This exercise suggests that the California unemployment rate exceeds the national unemployment rate by an average of about 2 percentage points because of forces exogenous to the state's labor market operations. However, this differential can be larger or smaller than 2 percentage points in accordance with differences in employment changes in construction and manufacturing between California and the nation as a whole.

FIGURE 1: CALIFORNIA LABOR FORCE AND EMPLOYMENT
(SEASONALLY ADJUSTED)

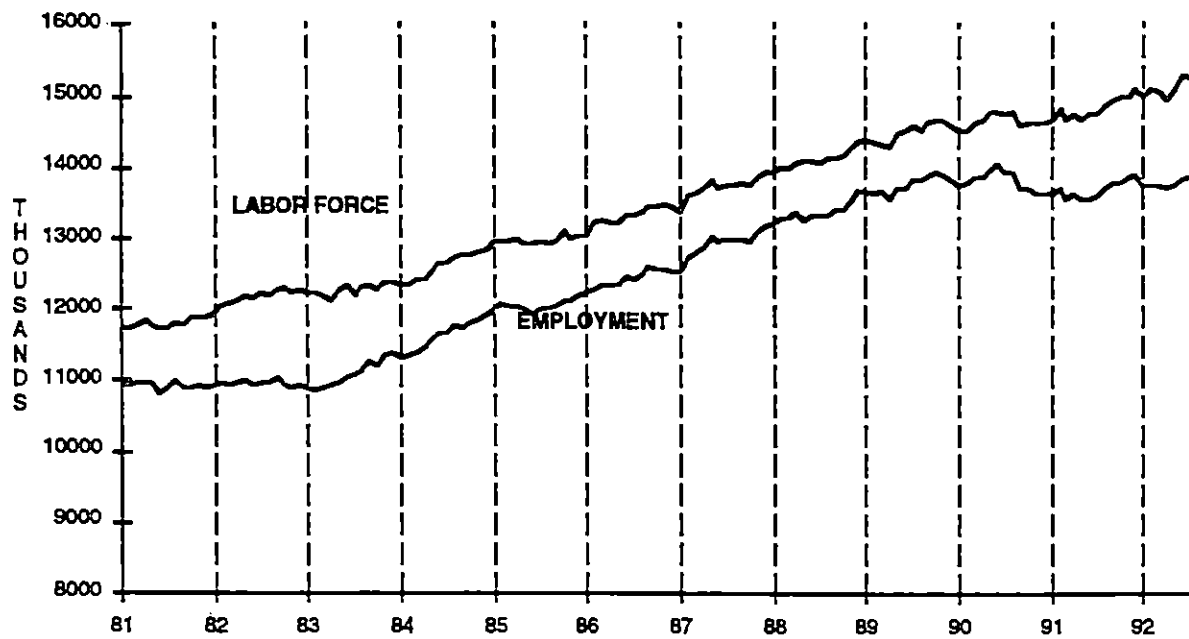
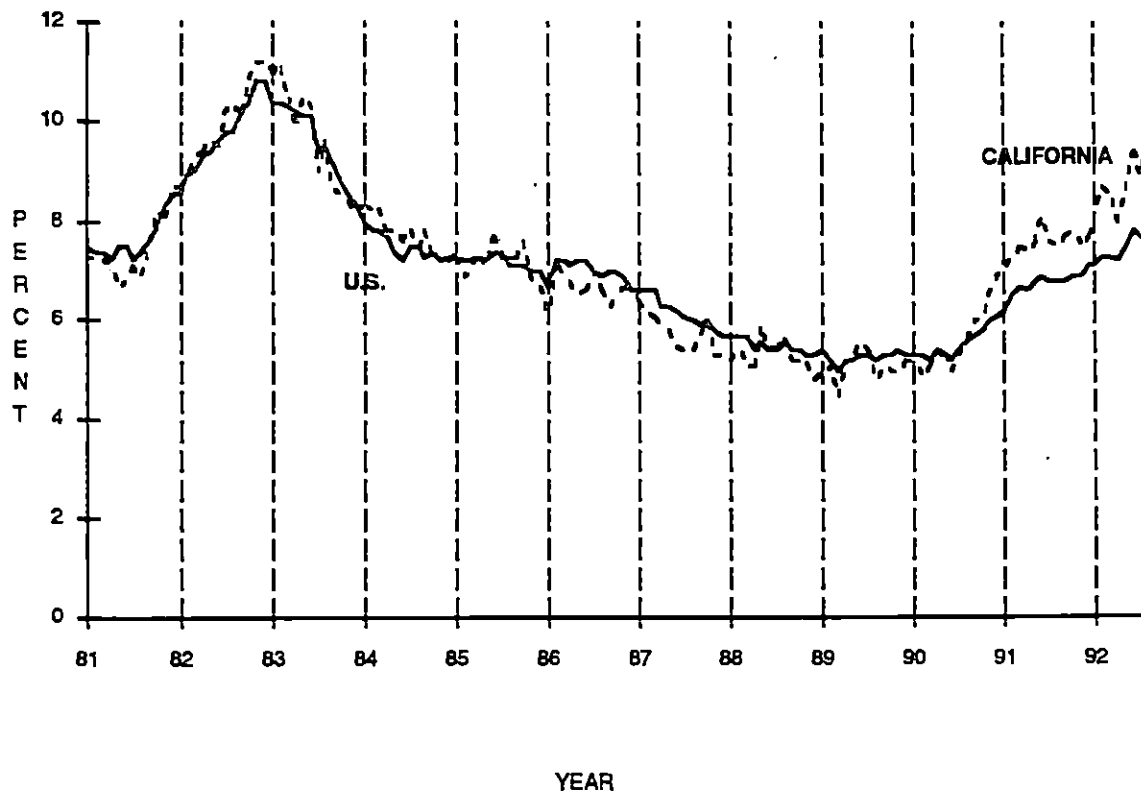


FIGURE 2: CALIFORNIA AND U.S. UNEMPLOYMENT RATES
(SEASONALLY ADJUSTED)



**FIGURE 4: CALIFORNIA LABOR MARKET INFORMATION AND
UNITED STATES UNEMPLOYMENT RATE**
SEASONALLY ADJUSTED
(IN THOUSANDS)

	JAN	FEB	MAR	APR	MAY	JUN	JUL	AUG	SEP	OCT	NOV	DEC	AA
CALIFORNIA LABOR FORCE													
1981	11756	11754	11781	11842	11783	11732	11755	11837	11788	11891	11913	11905	11812
1982	11971	12054	12074	12117	12193	12172	12225	12201	12293	12298	12254	12284	12178
1983	12234	12246	12200	12137	12282	12341	12213	12307	12357	12277	12397	12403	12281
1984	12363	12359	12421	12446	12526	12646	12655	12727	12766	12773	12806	12860	12610
1985	12968	12965	12964	12987	12926	12930	12954	12940	12981	13123	12998	13053	12981
1986	13032	13224	13276	13238	13225	13344	13354	13394	13466	13461	13505	13462	13332
1987	13392	13598	13639	13715	13846	13733	13755	13757	13805	13778	13872	13945	13737
1988	13972	14045	14010	14091	14117	14111	14087	14136	14140	14169	14313	14373	14133
1989	14403	14369	14345	14306	14489	14521	14613	14543	14651	14677	14671	14606	14518
1990	14518	14532	14634	14673	14784	14801	14752	14790	14612	14631	14640	14659	14670
1991	14685	14826	14667	14743	14686	14771	14748	14863	14967	14974	14982	15087	14833
1992	14975	15099	15064	14943	15093	15281	15245	15367	15297				
CALIFORNIA EMPLOYMENT													
1981	10931	10925	10975	10994	10977	10844	10921	11004	10898	10911	10958	10915	10938
1982	10953	10999	10961	10976	11010	11957	10964	10966	11047	10958	10888	10940	10967
1983	10900	10883	10918	10932	10984	11040	11105	11134	11278	11223	11357	11401	11095
1984	11326	11352	11395	11481	11543	11680	11653	11770	11751	11825	11868	11950	11631
1985	12016	12072	12052	12031	11996	11927	12023	12000	12035	12132	12117	12190	12048
1986	12253	12269	12357	12336	12360	12464	12420	12506	12611	12580	12599	12558	12442
1987	12536	12750	12805	12907	13038	12979	13007	13011	13018	12958	13137	13200	12946
1988	13241	13292	13291	13375	13278	13337	13333	13336	13409	13439	13562	13690	13385
1989	13686	13643	13697	13561	13742	13711	13828	13843	13899	13947	13931	13851	13780
1990	13769	13823	13890	13893	13999	14059	13974	13949	13740	13735	13662	13646	13846
1991	13653	13747	13565	13652	13570	13581	13623	13746	13816	13813	13864	13932	13714
1992	13759	13781	13785	13742	13778	13827	13881	13855	13859				
CALIFORNIA UNEMPLOYMENT													
1981	840	843	832	849	801	827	814	835	896	967	952	1036	875
1982	1026	1059	1120	1143	1171	1175	1250	1265	1252	1325	1368	1369	1210
1983	1336	1365	1286	1206	1292	1274	1098	1186	1082	1047	1045	1019	1187
1984	1039	1006	1028	957	977	963	992	964	1004	946	938	929	980
1985	955	891	916	957	923	998	927	943	944	994	882	869	934
1986	779	955	919	902	865	880	934	888	855	881	906	904	890
1987	856	848	834	808	808	754	748	746	787	820	735	745	791
1988	731	753	719	716	839	774	754	800	731	730	751	683	748
1989	717	726	648	745	747	810	785	700	752	730	740	745	737
1990	749	709	744	780	785	742	778	841	872	896	978	1013	823
1991	1032	1079	1102	1091	1116	1190	1125	1117	1151	1161	1118	1155	1119
1992	1216	1317	1278	1201	1315	1454	1364	1512	1438				
CALIFORNIA UNEMPLOYMENT RATE (%)													
1981	7.3	7.3	7.2	7.1	6.7	6.9	7.1	6.9	7.5	8.2	8.0	8.7	7.4
1982	8.7	8.9	9.3	9.4	9.6	9.5	10.3	10.3	10.1	10.8	11.2	11.2	9.9
1983	11.0	11.2	10.6	9.9	10.5	10.3	9.0	9.6	8.7	8.5	8.4	8.2	9.7
1984	8.4	8.2	8.3	7.8	7.8	7.6	7.9	7.5	7.8	7.4	7.3	7.2	7.8
1985	7.4	6.9	7.1	7.4	7.1	7.7	7.2	7.3	7.3	7.6	6.8	6.7	7.2
1986	6.0	7.2	6.9	6.8	6.5	6.6	7.0	6.6	6.3	6.5	6.7	6.7	6.7
1987	6.4	6.2	6.1	5.9	5.8	5.5	5.4	5.4	5.7	6.0	5.3	5.3	5.8
1988	5.2	5.4	5.1	5.1	5.9	5.5	5.4	5.7	5.2	5.2	5.2	4.8	5.3
1989	5.0	5.1	4.5	5.2	5.2	5.6	5.4	4.8	5.1	5.0	5.0	5.2	5.1
1990	5.2	4.9	5.1	5.3	5.3	5.0	5.3	5.7	6.0	6.1	6.7	6.9	5.6
1991	7.0	7.3	7.5	7.4	7.6	8.1	7.6	7.5	7.7	7.8	7.5	7.7	7.5
1992	8.1	8.7	8.5	8.0	8.7	9.5	8.9	9.8	9.4				
UNITED STATES UNEMPLOYMENT RATE (%)													
1981	7.5	7.4	7.4	7.2	7.5	7.5	7.2	7.4	7.6	7.9	8.3	8.5	7.6
1982	8.6	8.9	9.0	9.3	9.4	9.6	9.8	9.8	10.1	10.4	10.8	10.8	9.7
1983	10.4	10.4	10.3	10.2	10.1	10.1	9.4	9.5	9.2	8.8	8.5	8.3	9.6
1984	8.0	7.8	7.8	7.7	7.4	7.2	7.5	7.5	7.3	7.4	7.2	7.3	7.5
1985	7.3	7.2	7.2	7.3	7.2	7.4	7.4	7.1	7.1	7.1	7.0	7.0	7.2
1986	6.7	7.2	7.2	7.1	7.2	7.2	7.0	6.9	7.0	7.0	6.9	6.6	7.0
1987	6.6	6.6	6.6	6.3	6.3	6.2	6.1	6.0	5.9	6.0	5.8	5.7	6.2
1988	5.7	5.7	5.7	5.4	5.6	5.4	5.4	5.6	5.4	5.4	5.3	5.3	5.5
1989	5.4	5.2	5.0	5.2	5.2	5.3	5.3	5.2	5.3	5.3	5.4	5.3	5.3
1990	5.3	5.3	5.2	5.4	5.3	5.2	5.4	5.6	5.7	5.8	6.0	6.1	5.5
1991	6.2	6.5	6.7	6.6	6.8	6.9	6.8	6.8	6.8	6.9	6.9	7.1	6.7
1992	7.1	7.3	7.3	7.2	7.5	7.8	7.7	7.6	7.5				

FIGURE 8A: MONTHLY WAGE AND SALARY EMPLOYMENT
SEPTEMBER 1992

EMPLOYMENT IN THOUSANDS OF JOBS
 DATA NOT ADJUSTED FOR SEASONALITY

INDUSTRY TITLE (1987 SIC CODES)	SEPT1992	AUG 1992 (REVISED)	SEPT 1991	NUMERIC CHANGE MONTH/ MONTH	YEAR/ YEAR	PERCENT CHANGE MONTH/ MONTH	YEAR/ YEAR
TOTAL NONAGRICULTURE	12,278.2	12,208.5	12,506.4	69.7	-228.2	0.6	-1.8
NONAGRICULTURAL GOODS- PRODUCING INDUSTRIES	2,499.2	2,510.6	2,642.8	-11.4	-143.6	-0.5	-5.4
MINING	35.9	36.2	38.6	-0.3	-2.7	-0.8	-7.0
METAL MINING	2.2	2.2	2.1	0.0	0.1	0.0	4.8
NONMETALLIC MINERAL	5.9	5.9	6.1	0.0	-0.2	0.0	-3.3
OTHER MINING	27.8	28.1	30.4	-0.3	-2.6	-1.1	-8.6
CONSTRUCTION	521.0	525.5	562.6	-4.5	-41.6	-0.9	-7.4
GENERAL BUILDING CONTRACTORS	134.5	135.9	144.0	-1.4	-9.5	-1.0	-6.6
HEAVY CONSTRUCTION	66.0	65.1	68.9	0.9	-2.9	1.4	-4.2
SPECIAL TRADE CONTRACTORS	320.5	324.5	349.7	-4.0	-29.2	-1.2	-8.4
MANUFACTURING	1,942.3	1,948.9	2,041.6	-6.6	-99.3	-0.3	-4.9
DURABLE GOODS	1,208.7	1,211.8	1,292.6	-3.1	-83.9	-0.3	-6.5
LUMBER & WOOD PRODUCTS	54.4	55.0	57.6	-0.6	-3.2	-1.1	-5.6
FURNITURE & FIXTURES	45.7	45.7	48.8	0.0	-3.1	0.0	-6.4
STONE, CLAY, GLASS PRODUCTS	47.2	46.9	49.8	0.3	-2.6	0.6	-5.2
PRIMARY METAL INDUSTRIES	35.2	35.1	37.4	0.1	-2.2	0.3	-5.9
FABRICATED METAL PRODUCTS	117.5	116.5	123.0	1.0	-5.5	0.9	-4.5
INDUSTRIAL MACHINERY	204.2	205.1	212.6	-0.9	-8.4	-0.4	-4.0
ELECTRONIC EQUIPMENT	227.1	228.0	242.7	-0.9	-15.6	-0.4	-6.4
TRANSPORTATION EQUIPMENT	238.3	239.5	266.6	-1.2	-28.3	-0.5	-10.6
MOTOR VEHICLES & EQUIPMENT	30.9	31.2	31.4	-0.3	-0.5	-1.0	-1.6
AIRCRAFT & PARTS	129.3	129.8	146.3	-0.5	-17.0	-0.4	-11.6
SHIP, BOAT BUILDING & REPAIR	12.6	12.7	13.1	-0.1	-0.5	-0.8	-3.8
GUIDED MISSILES & SPACE VEHICLES	58.2	58.5	67.8	-0.3	-9.6	-0.5	-14.2
OTHER TRANSPORTATION & EQUIP	7.3	7.3	8.0	0.0	-0.7	0.0	-8.8
INSTRUMENTS & RELATED	204.4	205.1	218.7	-0.7	-14.3	-0.3	-6.5
MISC MANUFACTURING	34.7	34.9	35.4	-0.2	-0.7	-0.6	-2.0
NONDURABLE GOODS	733.6	737.1	749.0	-3.5	-15.4	-0.5	-2.1
LEATHER, LEATHER PRODUCTS	6.3	6.3	5.9	0.0	0.4	0.0	6.8
FOOD & KINDRED PRODUCTS	205.4	210.4	213.1	-5.0	-7.7	-2.4	-3.6
PRESERVED FRUITS & VEGTBLS	73.0	80.2	79.4	-7.2	-6.4	-9.0	-8.1
CANNED, CURED SEAFOOD	4.3	4.3	4.9	0.0	-0.6	0.0	-12.2
OTHER FOOD & KINDRED	128.1	125.9	128.8	2.2	-0.7	1.7	-0.5
TEXTILE MILL PRODUCTS	15.3	15.2	15.8	0.1	-0.5	0.7	-3.2
APPAREL & OTHER TEXTILE	136.7	135.6	136.3	1.1	0.4	0.8	0.3
PAPER & ALLIED PRODUCTS	40.4	40.3	40.5	0.1	-0.1	0.2	-0.2
PRINTING & PUBLISHING	157.3	156.9	162.0	0.4	-4.7	0.3	-2.9
CHEMICALS & ALLIED	72.8	73.0	72.9	-0.2	-0.1	-0.3	-0.1
PETROLEUM & COAL PRODUCTS	26.0	26.2	27.2	-0.2	-1.2	-0.8	-4.4
RUBBER & MISC PLASTIC PRODUCTS	73.4	73.2	75.3	0.2	-1.9	0.3	-2.5
NONAGRICULTURAL SERVICE- PRODUCING INDUSTRIES	9,779.0	9,697.9	9,863.6	81.1	-84.6	0.8	-0.9
TRANSPORTATION & PUBLIC UTILITIES	623.5	620.9	631.0	2.6	-7.5	0.4	-1.2
TRANSPORTATION	386.3	384.1	385.6	2.2	0.7	0.6	0.2
RAILROADS	16.1	16.1	16.8	0.0	-0.7	0.0	-4.2
TRUCKING & WAREHOUSING	160.0	159.1	161.2	0.9	-1.2	0.6	-0.7
WATER TRANSPORTATION	20.1	20.1	20.4	0.0	-0.3	0.0	-1.5
AIR TRANSPORTATION	99.7	99.5	97.1	0.2	2.6	0.2	2.7
OTHER TRANSPORTATION	90.4	89.3	90.1	1.1	0.3	1.2	0.3
COMMUNICATIONS	147.6	147.4	154.5	0.2	-6.9	0.1	-4.5
ELECTRIC, GAS, SANITARY SERVICES	89.6	89.4	90.9	0.2	-1.3	0.2	-1.4

FIGURE 8A (CONT.): MONTHLY WAGE AND SALARY EMPLOYMENT

SEPTEMBER 1992

EMPLOYMENT IN THOUSANDS OF JOBS
DATA NOT ADJUSTED FOR SEASONALITY

INDUSTRY TITLE (1987 SIC CODES)	SEPT1992	AUG 1992 (REVISED)	SEPT 1991	NUMERIC CHANGE MONTH/ MONTH	YEAR/ YEAR	PERCENT CHANGE MONTH/ MONTH	YEAR/ YEAR
TRADE	2,836.3	2,834.3	2,906.3	2.0	-70.0	0.1	-2.4
WHOLESALE TRADE	719.9	721.0	738.7	-1.1	-18.8	-0.2	-2.5
WHOLESALE - DURABLE	413.4	415.3	430.4	-1.9	-17.0	-0.5	-3.9
WHOLESALE - NONDURABLE	306.5	305.7	308.3	0.8	-1.8	0.3	-0.6
RETAIL TRADE	2,116.4	2,113.3	2,167.6	3.1	-51.2	0.1	-2.4
BUILDING MATLS, GARDEN SUPPLY	81.9	83.0	84.7	-1.1	-2.8	-1.3	-3.3
GENERAL MERCHANDISE STORES	221.6	220.8	231.4	0.8	-9.8	0.4	-4.2
FOOD STORES	304.5	300.5	314.6	4.0	-10.1	1.3	-3.2
AUTOMOTIVE DEALERS	208.9	209.5	212.3	-0.6	-3.4	-0.3	-1.6
APPAREL & ACCESSORIES	131.2	133.6	138.9	-2.4	-7.7	-1.8	-5.5
OTHER RETAIL TRADE	1,168.3	1,165.9	1,185.7	2.4	-17.4	0.2	-1.5
FINANCE, INSURANCE, & REAL ESTATE	802.1	804.8	817.5	-2.7	-15.4	-0.3	-1.9
REAL ESTATE	193.3	194.3	199.4	-1.0	-6.1	-0.5	-3.1
FINANCE INSTITUTIONS	382.8	383.8	389.3	-1.0	-6.5	-0.3	-1.7
DEPOSITORY INSTITUTION	258.2	259.2	269.0	-1.0	-10.8	-0.4	-4.0
NONDEPOSITORY INSTITUTIONS	54.4	54.3	52.2	0.1	2.2	0.2	4.2
SECURITY & COMMODITY	42.9	42.9	41.0	0.0	1.9	0.0	4.6
HOLDING & INVESTMENT	27.3	27.4	27.1	-0.1	0.2	-0.4	0.7
INSURANCE CARRIERS, AGENTS, BROKERS	226.0	226.7	228.8	-0.7	-2.8	-0.3	-1.2
SERVICES	3,467.9	3,461.2	3,465.2	6.7	2.7	0.2	0.1
HOTELS & OTHER LODGING	185.5	187.4	188.7	-1.9	-3.2	-1.0	-1.7
PERSONAL SERVICES	120.4	119.1	122.7	1.3	-2.3	1.1	-1.9
BUSINESS SERVICES	725.5	721.6	728.8	3.9	-3.3	0.5	-0.5
AUTOMOBILE & MISC REPAIR	178.0	178.2	182.4	-0.2	-4.4	-0.1	-2.4
AMUSEMENT, RECREATION	164.3	170.8	163.2	-6.5	1.1	-3.8	0.7
HEALTH SERVICES	824.5	823.7	812.9	0.8	11.6	0.1	1.4
EDUCATIONAL SERVICES	172.3	161.3	169.4	11.0	2.9	6.8	1.7
ENGINEERING & MANAGEMENT	396.1	397.1	401.5	-1.0	-5.4	-0.3	-1.3
MOTION PICTURES	129.5	130.1	130.0	-0.6	-0.5	-0.5	-0.4
OTHER SERVICES	571.8	571.9	565.6	-0.1	6.2	0.0	1.1
TOTAL GOVERNMENT	2,049.2	1,976.7	2,043.6	72.5	5.6	3.7	0.3
TOTAL FEDERAL GOVERNMENT	332.2	335.2	344.5	-3.0	-12.3	-0.9	-3.6
DEPARTMENT OF DEFENSE	118.8	119.3	123.3	-0.5	-4.5	-0.4	-3.6
OTHER FEDERAL GOVERNMENT	213.4	215.9	221.2	-2.5	-7.8	-1.2	-3.5
TOTAL STATE & LOCAL GOVERNMENT	1,717.0	1,641.5	1,699.1	75.5	17.9	4.6	1.1
TOTAL STATE GOVERNMENT	371.9	368.4	373.8	3.5	-1.9	1.0	-0.5
STATE EDUCATION	154.3	149.8	157.1	4.5	-2.8	3.0	-1.8
OTHER STATE GOVERNMENT	217.6	218.6	216.7	-1.0	0.9	-0.5	0.4
TOTAL LOCAL GOVERNMENT	1,345.1	1,273.1	1,325.3	72.0	19.8	5.7	1.5
LOCAL EDUCATION	722.0	637.0	707.0	85.0	15.0	13.3	2.1
COUNTY GOVT (NON-EDUC)	292.1	294.1	284.5	-2.0	7.6	-0.7	2.7
CITY GOVT (NON-EDUC)	223.5	234.3	227.4	-10.8	-3.9	-4.6	-1.7
SPECIAL DISTRICTS (NON-EDUC)	107.5	107.7	106.4	-0.2	1.1	-0.2	1.0
TOTAL AGRICULTURE	408.8	417.4	446.1	-8.6	-37.3	-2.1	-8.4
TOTAL, ALL INDUSTRIES	12,687.0	12,625.9	12,952.5	61.1	-265.5	0.5	-2.0

Economic Report of the Governor

1992



Submitted by
Pete Wilson
Governor
State of California

to the
California Legislature
1991 – 92 Regular Session

TABLE 3

TOTAL POPULATION OF CALIFORNIA
COUNTIES, JULY 1, 1990 AND 1991

County	1990	1991
Alameda	1,282,400	1,298,900
Alpine	1,100	1,200
Amador	30,600	31,900
Butte	183,900	189,500
Calaveras	32,500	35,000
Colusa	16,400	16,900
Contra Costa	810,300	827,100
Del Norte	24,500	27,000
El Dorado	128,200	135,200
Fresno	673,900	702,000
Glenn	25,000	25,600
Humboldt	119,800	122,300
Imperial	110,400	114,900
Inyo	18,400	18,700
Kern	549,800	572,700
Kings	102,500	105,900
Lake	51,100	53,500
Lassen	27,800	28,600
Los Angeles	8,897,500	9,003,500
Madera	89,800	95,400
Marin	231,200	235,000
Mariposa	14,500	15,400
Mendocino	81,000	82,800
Merced	180,600	185,000
Modoc	9,700	9,900
Mono	10,200	10,400
Monterey	358,800	364,000
Napa	111,700	113,400
Nevada	79,600	83,100
Orange	2,424,100	2,477,700
Placer	175,600	184,000
Plumas	19,900	20,400
Riverside	1,195,400	1,267,300
Sacramento	1,051,400	1,088,000
San Benito	37,000	37,500
San Bernardino	1,440,700	1,510,100
San Diego	2,520,500	2,574,200
San Francisco	723,900	724,200
San Joaquin	483,800	496,300
San Luis Obispo	219,500	220,500
San Mateo	652,100	663,400
Santa Barbara	371,400	375,900
Santa Clara	1,502,200	1,516,000
Santa Cruz	230,800	230,400
Shasta	148,800	156,300
Sierra	3,400	3,400
Siskiyou	43,800	44,700
Solano	345,700	361,500
Sonoma	392,000	402,400
Stanislaus	376,100	388,200
Sutter	65,100	68,000
Tehama	50,100	52,200
Trinity	13,100	13,300
Tulare	314,600	325,000
Tuolumne	49,000	51,400
Ventura	671,600	680,300
Yolo	142,500	148,100
Yuba	58,700	60,500
California	29,976,000	30,646,000

California Department of Finance,
Demographic Research Unit

TABLE 4

CIVILIAN LABOR FORCE, CALIFORNIA, 1967 TO 1991

(In thousands)				
	Labor force a/	Employed b/	Unem- ployed c/	Unemploy- ment rate (Percent)
1967	7,831	7,441	389	5.0
1968	8,090	7,724	366	4.5
1969	8,388	8,016	372	4.4
1970	8,167	7,575	592	7.3
1971	8,407	7,669	739	8.8
1972	8,653	7,996	656	7.6
1973	8,910	8,286	624	7.0
1974	9,317	8,638	679	7.3
1975	9,539	8,598	941	9.9
1976	9,896	8,990	906	9.2
1977	10,367	9,513	853	8.2
1978	10,911	10,137	775	7.1
1979	11,268	10,566	702	6.2
1980	11,584	10,794	790	6.8
1981	11,812	10,938	875	7.4
1982	12,178	10,967	1,210	9.9
1983	12,281	11,095	1,187	9.7
1984	12,610	11,631	980	7.8
1985	12,981	12,048	934	7.2
1986	13,332	12,442	890	6.7
1987	13,737	12,946	791	5.8
1988	14,133	13,385	748	5.3
1989	14,518	13,780	737	5.1
1990	14,670	13,846	823	5.6
1991	14,833	13,714	1,119	7.5
Adjusted for seasonal variation				
1990 January	14,518	13,769	749	5.2
February	14,532	13,823	709	4.9
March	14,634	13,890	744	5.1
April	14,673	13,893	780	5.3
May	14,784	13,999	785	5.3
June	14,801	14,059	742	5.0
July	14,752	13,974	778	5.3
August	14,790	13,949	841	5.7
September	14,612	13,740	872	6.0
October	14,631	13,735	896	6.1
November	14,640	13,662	978	6.7
December	14,659	13,646	1,013	6.9
1991 January	14,685	13,653	1,032	7.0
February	14,826	13,747	1,079	7.3
March	14,667	13,565	1,102	7.5
April	14,743	13,652	1,091	7.4
May	14,686	13,570	1,116	7.6
June	14,771	13,581	1,190	8.1
July	14,748	13,623	1,125	7.6
August	14,863	13,746	1,117	7.5
September	14,967	13,816	1,151	7.7
October	14,974	13,813	1,161	7.8
November	14,982	13,864	1,118	7.5
December	15,087	13,932	1,155	7.7

a/ Detail may not add to total due to rounding.

b/ Includes wage and salary workers, employers, own-account workers,
unpaid family workers and workers directly involved in work stoppages.c/ Excludes the potential or latent supply of workers not active
in the labor force.

Source: Employment Development Department

TABLE 5

**WAGE AND SALARY WORKERS IN NONAGRICULTURAL ESTABLISHMENTS
BY MAJOR INDUSTRY, CALIFORNIA, 1972 TO 1991 c/
(In thousands)**

Year	Total	Mining	Construc- tion a/	Manufac- turing	Trans- portation and utilities	Whole- sale trade	Retail trade	Finance, insurance, real estate	Services	Govern- ment b/
1972	7,209.9	29.2	312.4	1,542.7	454.1	409.6	1,199.0	409.3	1,361.0	1,492.7
1973	7,621.9	30.5	333.4	1,660.7	467.0	441.6	1,261.9	431.6	1,470.6	1,524.8
1974	7,834.3	32.7	317.8	1,701.3	470.7	460.6	1,291.4	444.8	1,529.1	1,586.0
1975	7,847.2	33.9	285.9	1,593.7	458.1	465.9	1,320.4	446.4	1,572.4	1,670.6
1976	8,154.2	34.7	301.3	1,659.8	463.9	485.3	1,390.2	468.7	1,654.6	1,695.6
1977	8,599.7	35.6	350.4	1,737.8	476.5	507.5	1,474.9	505.4	1,770.9	1,740.7
1978	9,199.8	37.1	401.9	1,884.6	506.4	534.3	1,591.7	553.2	1,937.4	1,753.1
1979	9,664.6	39.3	448.7	2,012.7	534.7	564.1	1,659.7	595.9	2,074.6	1,735.0
1980	9,848.8	43.5	428.3	2,018.2	546.3	583.7	1,683.2	623.1	2,158.8	1,763.9
1981	9,985.3	49.2	407.6	2,032.3	554.8	590.6	1,710.9	642.9	2,240.5	1,756.4
1982	9,810.3	50.4	349.0	1,957.7	542.8	582.1	1,693.1	642.4	2,257.7	1,735.2
1983	9,965.8	48.1	369.3	1,949.3	536.9	603.8	1,740.1	661.7	2,332.2	1,724.3
1984	10,573.8	50.0	445.2	2,065.5	554.6	643.4	1,864.0	694.2	2,509.5	1,747.4
1985	10,979.1	49.9	496.2	2,076.1	568.7	673.5	1,952.7	724.5	2,644.8	1,792.8
1986	11,258.1	42.6	531.0	2,069.7	574.6	680.4	2,006.1	763.7	2,751.3	1,838.8
1987	11,678.5	41.1	574.6	2,107.6	582.6	689.4	2,072.0	800.9	2,926.7	1,883.7
1988	12,103.4	42.0	603.3	2,149.2	589.0	730.1	2,144.3	807.3	3,104.1	1,934.1
1989	12,569.9	40.2	648.1	2,161.4	607.1	763.8	2,210.1	832.8	3,307.8	1,998.7
1990	12,830.1	39.9	650.4	2,126.8	633.8	774.9	2,241.4	839.2	3,448.9	2,074.8
1991	12,497.1	38.8	550.7	2,025.8	628.1	738.7	2,171.8	819.4	3,444.9	2,078.9

a/ Includes employees of construction contractors and operative builders; does not include force-account and government construction workers.

b/ Includes all civilian employees of Federal, State, and local governments regardless of the activity in which the employees are engaged.

c/ There may be breaks in series between 1971-1972 and 1987-1988 due to changes in Standard Industrial Classification. Does not include employers, own-account workers, unpaid family workers, domestic servants, and agricultural workers. (Official U.S. Bureau of Labor Statistics series. The text portion of the report uses the interim series prepared by the Department of Finance.)

Source: California Employment Development Department

TABLE 6

**WAGE AND SALARY WORKERS IN NONAGRICULTURAL ESTABLISHMENTS
BY MAJOR INDUSTRY, SELECTED AREAS, 1990 AND 1991 a/
(In thousands)**

Area b/ and year	Total	Mining	Construc- tion	Manufac- turing	Trans- portation and utilities	Trade	Finance, insurance, real estate	Services	Govern- ment
Anaheim-Santa Ana									
1990	1,205.1	1.3	66.2	250.3	37.7	301.4	99.7	322.4	126.1
1991	1,159.5	1.4	54.8	236.4	37.3	282.1	96.6	322.2	128.7
Bakersfield									
1990	174.9	14.1	11.7	10.7	8.8 b/	41.2	6.5	37.7	44.0
1991	179.6	13.9	11.5	10.3	9.3 b/	42.5	6.3	40.2	45.5
Fresno									
1990	229.4	0.6	14.2	26.4	12.4	58.4	13.1	53.5	50.7
1991	229.2	0.7	13.8	26.1	12.5	56.2	13.3	54.7	51.9

TABLE 7

WAGE AND SALARY WORKERS IN MANUFACTURING, CALIFORNIA 1983 TO 1991 a/
(In thousands)

Industry	1983	1984	1985	1986	1987	1988	1989	1990	1991
Total	1,949.3	2,065.5	2,076.1	2,069.7	2,107.6	2,149.2	2,161.4	2,126.8	2,025.8
Nondurable goods	622.0	639.2	635.7	652.7	680.4	703.3	719.3	730.9	721.9
Durable goods	1,327.3	1,426.3	1,440.4	1,417.0	1,427.2	1,445.9	1,442.1	1,395.9	1,303.9
Nondurable goods:									
Food and kindred products	173.4	173.3	169.2	170.6	171.4	175.7	180.5	185.7	184.9
Canned, cured, frozen sea foods b/	8.9	6.8	5.2	5.5	5.7	5.9	4.9	4.5	4.6
Meat products	16.7	17.1	17.4	17.4	19.2	19.5	20.3	21.1	20.4
Dairy products	13.5	13.0	12.6	12.6	12.3	12.9	13.8	14.8	14.5
Canned/preserved fruit and vegetables b/	52.0	53.6	51.3	50.4	50.6	49.1	52.3	54.5	53.7
Grain mill products	8.3	8.2	8.0	8.1	8.4	8.5	8.9	9.9	9.6
Bakery products b/	19.0	19.4	19.4	20.0	19.2	20.4	20.8	21.2	21.9
Beverages	25.4	25.2	25.6	26.7	26.8	28.4	28.2	27.8	27.7
Other food and kindred products	29.7	30.0	29.8	30.0	29.3	30.9	31.4	32.1	32.4
Textile mill products	13.0	13.7	13.9	14.9	16.3	16.6	17.0	16.5	15.5
Knitting mills	2.7	3.3	3.8	4.3	4.6	4.3	4.6	4.7	4.8
Floor covering mills	3.8	4.0	3.9	4.1	4.3	4.5	4.7	4.1	3.8
Other textile mill products	6.4	6.4	6.2	6.5	7.5	7.9	7.7	7.7	7.0
Apparel and other textile products	103.2	108.0	107.2	114.7	126.4	126.1	131.6	136.5	137.6
Men's, boys' suits and coats b/	12.0	11.5	9.6	9.5	10.1	9.5	8.8	8.9	8.4
Women's and misses' outerwear	63.1	67.0	69.3	75.7	84.4	84.3	87.6	91.3	94.7
Women's and children's undergarments	4.0	4.1	3.8	3.9	3.8	3.7	3.8	3.7	3.2
Girls', child's outerwear	2.1	2.3	2.1	2.4	2.7	2.7	3.1	3.3	3.6
Other apparel and textile products b/	21.9	23.1	22.4	23.2	25.4	26.0	28.4	29.4	27.8
Paper and allied products	37.0	38.7	39.6	40.0	41.1	40.7	41.8	41.6	40.3
Misc. converted paper products	15.2	15.8	15.9	16.4	16.9	17.0	17.2	16.8	16.0
Paperboard containers and boxes	15.5	16.7	17.6	17.5	18.0	17.7	18.2	18.4	18.2
Other paper and allied products b/	6.3	6.2	6.1	6.1	6.2	6.0	6.4	6.5	6.0
Printing and publishing	128.3	136.5	140.1	145.1	152.4	161.5	163.1	166.2	162.9
Newspapers	43.2	46.4	47.7	48.9	50.7	52.8	52.3	53.4	51.9
Commercial printing	50.7	53.3	54.3	56.0	58.9	61.9	63.5	64.5	63.9
Other printing and publishing	34.5	36.8	38.1	40.2	42.8	46.8	47.3	48.2	47.1
Chemicals and allied products	63.8	64.1	63.7	64.7	67.8	73.2	73.4	72.5	72.6
Industrial inorganic chemicals b/	7.1	7.4	7.4	7.4	7.1	7.3	7.6	7.5	7.4
Plastics materials and synthetics	3.3	3.3	3.1	2.9	3.0	3.4	3.4	3.6	3.3
Drugs b/	19.5	19.3	19.0	20.1	21.4	24.1	24.2	23.5	24.4
Soaps, cleaners, toilet goods	12.1	12.4	12.4	13.0	14.4	15.6	15.2	14.7	14.4
Paints and allied products	6.7	7.2	7.5	7.5	7.5	7.4	7.3	7.3	7.0
Agricultural chemicals	4.1	3.9	3.6	3.3	3.2	3.0	2.9	3.0	3.5
Other chemicals and allied products	10.9	10.7	10.8	10.6	11.2	12.3	12.9	13.0	12.8
Petroleum and coal products	31.0	30.0	28.8	27.7	27.3	27.8	28.2	27.1	27.0
Petroleum refining	27.5	26.5	25.7	24.7	24.2	24.5	24.8	23.6	23.6
Other petroleum and coal products b/	3.6	3.5	3.1	3.0	3.1	3.3	3.5	3.5	3.5
Rubber and miscellaneous plastics product	62.8	66.5	65.7	68.1	70.7	75.4	77.3	78.6	75.1
Tires and inner tubes	1.3	1.3	1.2	1.1	1.1	1.1	1.1	1.1	1.1
Footwear and fabricated products b/	10.0	10.4	10.0	9.9	9.9	10.1	9.6	9.1	8.4
Misc. plastics products b/	50.5	54.1	53.6	55.9	58.6	60.5	62.3	63.7	60.7
Other rubber and plastics products b/	0.9	0.8	1.0	1.2	1.2	3.7	4.3	4.7	4.9
Leather and leather products	9.5	8.5	7.5	7.0	6.9	6.3	6.3	6.1	6.0
Durable goods:									
Lumber and wood products excl. furniture	50.6	55.1	56.1	60.1	66.2	69.2	71.4	68.1	56.1
Logging camps, sawmills, planing mills	19.7	20.9	20.5	20.9	22.3	22.6	21.7	20.3	16.3
Millwork, plywood, structural members	14.3	16.9	18.4	20.9	24.4	26.5	29.2	27.7	22.6
Wooden containers	3.7	4.0	4.1	4.6	4.7	4.6	4.5	4.7	4.5
Other lumber and wood products	12.9	13.2	13.0	13.7	14.9	15.5	15.9	15.3	12.7
Furniture and fixtures	51.6	59.2	58.9	59.5	63.0	62.0	60.4	56.4	49.1
Household furniture	31.1	34.9	34.2	34.5	37.3	37.0	34.2	31.0	27.1
Partitions and fixtures b/	6.8	8.4	8.3	8.4	8.7	8.6	8.6	8.3	7.5
Other furniture and fixtures	13.8	16.0	16.5	16.6	17.0	16.4	17.6	17.1	14.5

TABLE 7 (Continued)

WAGE AND SALARY WORKERS IN MANUFACTURING, CALIFORNIA 1983 TO 1991 a/
(In thousands)

Industry	1983	1984	1985	1986	1987	1988	1989	1990	1991
Stone, clay and glass products	48.7	51.6	50.8	52.5	53.7	54.3	56.7	56.2 /	49.9
Glass and glass products	15.8	15.8	15.1	15.3	15.5	15.6	16.0	15.9	14.0
Hydraulic cement b/	3.3	3.2	2.9	2.9	2.8	2.1	2.0	1.8	1.8
Structural clay products	2.4	2.3	2.2	2.2	2.2	2.4	2.7	3.0	2.6
Pottery and related products b/	4.5	4.7	4.1	4.1	4.3	5.0	5.4	5.1	4.5
Concrete, gypsum, plaster products	14.2	16.5	17.2	18.3	19.4	21.0	22.0	22.0	19.3
Other stone, clay and glass products b/	8.4	9.1	9.4	9.9	9.5	8.3	8.6	8.4	7.8
Primary metal industries	43.5	42.6	41.6	40.8	42.0	43.7	43.4	41.1	37.9
Blast furnace and basic steel products	9.9	7.7	7.9	7.7	8.1	8.8	9.0	8.3	7.7
Iron and steel foundries	6.5	6.7	6.4	6.1	6.6	6.7	6.2	5.6	5.3
Nonferrous rolling and drawing	13.4	13.7	13.3	12.8	12.7	12.8	12.9	12.3	11.5
Nonferrous foundries	9.7	10.3	10.0	10.3	10.7	10.7	10.6	10.2	9.0
Other primary metals b/	4.0	4.2	4.1	3.9	3.9	4.6	4.7	4.7	4.4
Fabricated metal products	137.9	146.7	143.5	135.9	134.3	138.7	139.3	134.8 /	123.5
Metal cans and shipping containers	8.9	8.4	8.3	7.9	7.5	7.2	6.9	6.6	6.2
Cutlery, hand tools, hardware	14.1	15.0	14.3	14.0	14.5	15.8	15.0	14.0	12.7
Plumbing and heating excl. electric b/	6.7	7.4	7.7	7.4	7.0	8.2	8.7	8.4	7.8
Fabricated structural products	44.5	47.0	45.1	41.7	40.5	40.3	41.3	40.7	37.4
Screw machine products, bolts, etc.	11.4	12.4	12.6	12.3	13.1	13.4	13.2	13.5	12.6
Forgings and stampings	14.2	15.7	15.8	15.6	15.0	14.1	13.6	13.4	11.8
Metal services	18.9	20.3	19.9	19.3	20.2	20.9	21.4	20.4	19.9
Other fabricated metal products b/	19.2	20.5	19.9	17.6	16.7	18.9	19.1	17.8	15.2
Industrial machinery	223.4	239.2	229.4	214.0	212.3	219.3	224.1	219.3	215.3
Farm and garden	4.7	4.6	4.3	3.7	4.1	4.2	3.7	2.9	2.3
Construction and related	14.1	14.3	13.5	11.1	9.8	9.7	9.7	9.0	8.0
Metalworking b/	16.3	17.8	17.7	16.3	16.3	19.1	19.2	18.0	16.6
Special industry b/	12.6	13.7	13.3	12.0	12.0	10.7	10.9	11.2	10.8
General industry b/	18.3	19.7	19.7	18.2	18.0	17.9	19.0	19.3	19.3
Computer and office equipment b/	109.9	117.9	111.4	107.2	105.8	102.9	105.7	103.6	104.1
Refrigeration and service industry mach.	8.4	8.6	9.2	9.0	9.1	9.5	9.3	9.0	9.0
Other machinery and equipment b/	39.2	42.6	40.3	36.5	37.2	45.3	46.5	46.3	45.2
Electrical equipment and supplies b/	365.4	406.3	413.4	399.7	396.9	270.4	268.0	259.4	244.8
Electrical distribution equipment b/	8.0	10.7	11.7	11.5	11.9	12.2	11.7	10.4	9.1
Electrical industrial b/	12.1	14.4	13.2	11.2	10.3	12.7	12.2	11.0	9.9
Household appliances	4.5	3.9	3.9	3.8	4.0	4.0	4.2	3.8	3.2
Lighting and wiring equipment	20.0	22.0	22.6	23.2	23.4	23.7	23.7	23.1	20.8
Household audio and visual	13.5	13.7	13.6	14.0	14.5	15.1	15.5	15.7	15.7
Communication equipment b/	158.7	167.2	179.1	179.5	174.3	31.7	32.5	31.3	29.8
Electronic components and accessories	139.8	165.3	160.8	148.6	150.4	147.8	146.5	142.8	136.2
Misc. electrical equip. and supplies	8.9	9.2	8.4	7.9	8.2	23.3	21.8	21.5	20.2
Transportation equipment	261.9	277.5	297.3	306.7	310.2	304.0	302.4	296.9	271.1
Motor vehicles and equipment	30.3	33.4	33.6	32.5	33.3	34.7	33.3	30.6	30.3
Aircraft and parts b/	133.3	141.1	156.7	167.4	171.6	163.6	165.6	166.9	149.9
Ship and boat building and repairing	18.7	18.2	17.5	15.4	13.6	13.4	14.2	12.9	12.8
Guided missiles, space vehicles and parts	69.3	73.8	78.1	81.0	81.1	81.9	79.9	77.8	70.0
Other transportation equipment	10.4	11.1	11.4	10.4	10.5	10.3	9.4	8.8	8.1
Instruments and related products b/	103.7	110.1	113.9	112.2	112.9	247.7	239.4	227.2	221.0
Search and navigation c/	n.a.	n.a.	n.a.	n.a.	n.a.	126.7	114.5	102.1	96.7
Measuring and controlling b/	47.5	51.1	54.1	54.3	54.5	70.9	73.3	71.4	69.4
Other instruments and related products b/	56.2	59.0	59.8	58.0	58.4	50.1	51.6	53.7	54.9
Miscellaneous manufacturing	40.6	37.9	35.5	35.5	35.8	36.7	37.1	36.6	35.1
Toys and sporting goods	18.3	15.1	13.2	12.4	12.4	12.1	12.1	12.2	12.3
Other misc. manufacturing	22.3	22.9	22.3	23.0	23.5	24.6	25.0	24.4	22.8

a/ Data for 1983-1987 are based on the 1972 SIC codes. 1988-1990 are based on the 1987 SIC codes.

b/ Data for 1988-1990 are not comparable with prior years due to SIC code changes.

c/ Not published on the 1972 SIC code.

n.a. Not available

Source: California Employment Development Department

(Official U.S. Bureau of Labor Statistics series. The text portion of the report uses the Interim series prepared by the Department of Finance.)

TABLE 8

AEROSPACE AND ELECTRONICS EMPLOYMENT, CALIFORNIA, 1960 TO 1991 a/b/
(In thousands)

Year	Total aerospac	Office and computing machines	Radio and T.V. receiving equipment	Communi- cation equipment	Electronic components and accessories	Aircraft and parts	Guided missiles and space vehicles	Measuring and controlling devices
1960	422.5	23.3	9.9	92.2		181.4	68.4	18.2
1961	425.8	23.6	10.6	98.8	29.1	166.0	76.2	19.5
1962	457.6	25.4	12.0	112.0	31.2	161.0	89.6	22.1
1963	458.3	25.6	11.9	110.4	35.4	160.1	93.7	21.8
1964	433.5	26.9	11.0	98.1	34.8	153.6	90.8	20.8
1965	434.3	30.2	10.8	95.7	32.4	155.3	86.0	21.4
1966	495.0	33.8	13.7	103.3	34.9	181.3	92.1	23.1
1967	542.4	38.8	15.0	117.6	47.7	198.6	97.4	23.0
1968	544.3	42.7	15.5	117.0	52.0	195.4	96.9	24.6
1969	528.3	53.4	16.7	114.4	52.4	178.3	82.6	25.3
					57.7			
1970	466.3	58.3	15.1	102.9	53.0	148.3	64.5	24.3
1971	409.6	52.3	14.2	91.1	45.9	130.3	52.9	23.0
1972	427.4	52.1	15.0	95.1	52.0	135.4	52.8	25.1
1973	462.8	61.4	15.5	100.0	68.9	135.6	51.0	30.5
1974	485.8	69.7	15.8	102.6	78.5	134.9	51.7	32.7
1975	450.5	63.3	14.9	103.0	65.7	121.3	52.0	30.2
1976	449.6	62.3	16.1	105.4	74.8	108.5	50.0	32.5
1977	465.2	67.0	16.6	108.4	82.3	109.4	48.0	33.5
1978	518.8	80.1	17.8	119.1	97.3	117.5	49.6	37.4
1979	590.6	92.2	18.0	129.6	114.6	140.4	54.0	41.9
1980	632.6	97.9	17.6	137.3	124.2	151.0	58.6	46.0
1981	647.1	98.4	17.3	146.5	126.1	147.9	62.7	48.2
1982	658.3	103.9	14.9	157.2	131.0	137.3	66.4	47.6
1983	672.0	109.9	13.5	158.7	139.8	133.3	69.3	47.5
1984	730.0	117.9	13.7	167.2	165.3	141.1	73.8	51.1
1985	753.7	111.4	13.6	179.1	160.8	156.7	78.1	54.1
1986	752.0	107.2	14.0	179.5	148.6	167.4	81.0	54.3
1987	752.2	105.8	14.5	174.3	150.4	171.6	81.1	54.5

Total High Tech- nology	Aerospace				Electronics		
	Aircraft and parts	Missiles and space vehicles	Search and navigation instruments	Computer and office equipment	Communi- cations equipment	Electronic components	Laboratory measuring, controlling instruments
1988	725.5	163.6	81.9	126.7	102.9	31.7	147.8
1989	718.0	165.6	79.9	114.5	105.7	32.5	146.5
1990	695.8	166.9	77.8	102.1	103.6	31.3	142.8
1991	656.1	149.9	70.0	96.7	104.1	29.8	136.2

a/ Wage and salary workers.

b/ Data from 1960-1971 calculated using aerospace categories as defined by 1972 SIC codes. Data from 1972-1987 represent the official benchmarked aerospace series based upon the 1972 SIC codes. Data beginning in 1988 are based on the 1987 SIC codes. (Official U.S. Bureau of Labor Statistics series. The text portion of the report uses the interim series prepared by the Department of Finance)

Source: California Employment Development Department

October 29, 1992

Robert Zoellick
Deputy Chief of Staff
Office of the President
White House
1600 Pennsylvania Ave NW
Washington, D.C. 20205

Dear Mr. Zoellick:

Thank you for your letter in response to mine.

Urgent, a two minute television spot featuring the President and Dr. Wilensky discussing the pros and cons of the Bush/Clinton proposals for healthcare cost containment and health insurance reform, and limiting tax deductibility of health insurance premiums.

In the end, it may be the critical difference between winning and losing.

Sincerely,

John Holper

John Holper
22 W. 419 Balsam
Glen Ellyn, IL 60137

Enclosure

cc: James A. Baker III

in the nation's
supporters are
de route for

Election 1992

Party power: Republican and Democratic parties at the state level have injected at least \$35 million of their own money to mobilize voters, an Associated Press review has found.



Candidates target uninsured, spiraling costs

By Rogers Worthington

Health care reform, an idea that flourished and faded earlier this year, has re-emerged as a defining issue in the closing days of the presidential campaign.

The economic consequences of an unreformed system loom larger than ever. Last week the Congressional Budget Office predicted that the nation's annual health care bill would double by the year 2000, and the number of uninsured would grow to 39 million.

But to learn where the candidates stand, one must wade through a thicket of misleading accusations. For example, George Bush claims the Clinton plan is "a prescription for disaster." Bill Clinton says Bush's plan is little more than "the same old placebos." Neither is true.

So far, Ross Perot, who has less of a plan than an approach, has stayed out of the fray.

All three candidates have one thing in common on the issue: None would move toward the national, Canadian-style health insurance system that many health activists say would be the cheapest and most efficient, and that critics say would result in waiting lines.

The Bush and Clinton plans have further similarities. Both would seek to cut costs by promoting managed competition, a structured way to compel insurers to compete for large blocs of consumers on price and quality of care—in essence, giving consumers more purchasing clout.

And both would promote managed care, such as HMOs, which are paid a fixed price to cover all of an enrollee's health care needs. Managed care restricts the choice of physician but has a strong self-interest in keeping patients healthy.

Both plans would bar insurers from rejecting someone because of a pre-existing condition, a major concern for employees reluctant to change jobs for fear of losing their coverage. Both would preserve Medicare for the elderly. Both would seek to cut malpractice suits and streamline the billing paperwork of health insurance claims. And both are vague on how they would pay the full bill for their reforms. Neither, however, confronts another looming prob-

On the issues:

Health care

This is part of an occasional series of reports intended to highlight the presidential candidates' positions on specific issues.

lem: long-term care for a growing elderly population.

But the similarities end there.

Bush's plan would provide tax deductions for the middle class and refundable federal government health insurance credits, or vouchers, for the poor.

Here's how it would work: Those who are insured through work, but whose employers pay less than \$3,750 a year of the premiums (for a family), could deduct their share of the premiums. The self-employed could deduct 100 percent of their health insurance costs. And a family of four with income of up to \$80,000 without employer-paid health insurance could take a tax deduction of \$3,750.

A family of four at the poverty line (annual income of \$14,300) would be eligible for the maximum voucher of \$3,750, which could be used only to buy health insurance. Singles would get \$1,250 and couples \$2,500. But the size of the voucher would quickly diminish with rising income. A family of four earning \$23,400, for example, would get \$563; a single person earning \$9,075 would get \$188.

Small businesses would be aided by the creation of health insurance networks—doctors, hospitals, clinics—and multi-state purchasing pools, along with low-cost group insurance plans that the government would encourage states and insurance companies to develop.

Bush's plan would pay for part of the estimated \$100 billion it would cost over five years by eliminating the federal government's share of Medicaid money that hospitals now get for uncompensated care. But he has said he also may impose expenditure caps and cuts to Medicaid and Medicare and other so-called entitlement programs, a move that could reduce coverage for the elderly and poor recipients

of those programs.

Critics say the Bush plan does not cover all the uninsured; makes only a halfhearted stab at cost control; goes halfway in reforming insurance company underwriting practices; and doesn't do enough to make health care affordable for the two-thirds of the nation's 37 million uninsured marginally above the poverty level.

Clinton's new plan, a beefed-up version of Hawaii's health care system, requires all employers to provide insurance for their employees, with no option to dodge participation by paying into a cheaper federal fund for the uninsured.

For small employers operating with a slim profit margin, Clinton would provide tax assistance. The self-employed would get a full tax deduction.

For the unemployed, the federal government under the Clinton plan would guarantee private coverage through creation of publicly sponsored insurance purchasing groups, which would utilize Medicaid monies. Those below poverty level would pay nothing; a sliding scale would be applied for those above the poverty level.

Clinton would require insurers to provide preventive care and, like Bush, would establish publicly sponsored purchasing pools of small businesses that would band together for greater negotiating power.

But he would do four things the Bush plan does not:

- Create a national health care board that would set national and state health care budgets, or spending targets. If prices threatened to exceed the target, states could set price limits for doctors and hospitals. The board also would set a ceiling premium price for a standard benefit package.

- Expand long-term care by giving the elderly the option to take money available previously only for nursing homes and spend it on home health care, nursing services and transportation.

- Eliminate tax breaks for drug companies that raise retail prices more than the rate of inflation.

- Require insurers to "community-rate" all businesses in an area, rather than set discriminatory rates on smaller businesses based on the

health, age and sex of the ployees.

Critics say the Clinton short on detail about how it pay for the uninsured, how the subsidies would be for the income range up to 1: cent of the poverty level, at the national health budget would wield its power and price ceilings at the local. They point out that gove cost controls have a dismal and claim such an approach only put a lid, rather tha down the flame, on the boil of health care cost increases.

Ross Perot sketched an ou his ideas on health care rel his book "United We Stand.

His approach has the fede ernment helping states tement their own innoc health plans, within some requirements.

He sees a public-private ship as the linchpin to health care system. In th term, he calls for an imi two-pronged program of cc tainment and preventive m. Such a program would be t out in workshop sessions l health care experts, consum government officials.

Perot claims he would sa billion in federal spending c years by improving the qua delivery of Medicare and N services. He would deny N benefits for the rich.

His one concrete cost proposal would be to tax ers' contributions to heal plans over \$335 a montl family and \$135 for an indi

This would make emplo inclined to pay for "C: health care plans, which co to runaway medical costs b ing consumers from awar the high cost of services, i unnecessary tests and proce

For the longer term, Perc loosen federal payroll de rules so states would be enc to develop their own cor sive universal health care programs.

Because Perot's primary ment is to slash the deficit, more about cost control tl versal access, although h cates the latter.

10-29-92 CT

Conservative Victory Committee

NRN

L. Brent Bozell, III
Executive Director

October 22, 1992

Mr. James A. Baker III
Chief of Staff and Senior Counsellor to the President
The White House
Washington, DC 20500

Dear Mr. Baker:

As you are probably aware, yesterday two Republican governors campaigning with the President tried to lay the blame for President Bush's potential defeat on conservatives. Specifically, Governors Carroll Campbell and Jim Martin attacked Pat Buchanan personally, while other aides swiped at Bill Bennett and Jack Kemp. Such comments demonstrate not only the continued disdain for conservatives among some in the Bush Administration, but also their country club elitism.

Governors Martin and Campbell claimed that conservatives are to blame if the President should lose in November. This is first preposterous, second cowardly, and third politically naive.

These accusations are preposterous. For three years George Bush consistently broke the campaign promises made to the conservatives who had provided him his margin of victory in 1988. Some of these broken promises caused our economic recession and are the primary reason for the President's current political troubles. Now that we have increased taxes, regulation, and spending, it is inane to blame conservatives for problems created by George Bush alone.

It is cowardly because some in the moderate wing of the Republican Party refuse to admit that the roll-back of the Reagan Revolution is destroying a once seemingly indestructible G.O.P. This revolution brought about one of the largest economic expansions in the 20th century. It came as a direct result of the conservative philosophy of limited government, not the liberal philosophy of increased government --- the path chosen in the last three years.

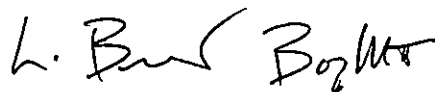
The political naivete of some in Bush's inner circle is mind-boggling. Instead of uniting the Party behind the President as he goes on the offensive in the waning days of the campaign, they attack the base of the Republican Party. Just as the President begins to pick up steam, these "Party pros" are pulling the rug out from under him.

Furthermore, these eleventh hour attacks on Pat Buchanan, Jack Kemp and Bill Bennett are the epitome of two-faced, back-stabbing politics. All three men are criss-crossing the country attempting to save the Bush campaign at the request of

the Bush campaign whose spokesmen then attack them. And we wonder why we are losing.

I supported George Bush in 1988. I supported Buchanan in the '92 primaries and support President Bush for re-election now. Likewise, most other conservatives have endorsed the President and closed ranks behind him, putting differences aside in order to help him win. I urge you to use campaign funds to buy muzzles for those who are once again alienating the conservatives, for Bush cannot win without overwhelming conservative support.

Sincerely,



L. Brent Bozell III
Executive Director
Conservative Victory Committee

cc: Governor Jim Martin (R-NC)
Governor Carroll Campbell (R-SC)
RNC Chairman Rich Bond

original returned to Marilyn Newman
10/26/92

MORTGAGE DISCRIMINATION TALKING POINTS

The data gathered under the Home Mortgage Disclosure Act and the recent study by the Federal Reserve Bank of Boston clearly suggest that discrimination in mortgage lending is a genuine problem in the private sector. The Bush Administration has taken early and aggressive steps to deal with this issue:

- The Justice Department has undertaken a substantial and continuing investigation of mortgage lending practices. Most recently, the Department entered into a consent decree with Decatur Federal Savings, imposing a penalty of over \$1 million. [This is the first such victory by any Administration in a mortgage discrimination case.]
- The OCC has begun close scrutiny of 250 banks that HMDA data show may have discriminated.
- [The Justice Department is making arrangements to accompany regulators on examinations of certain banks and thrifts to assess compliance with federal nondiscrimination laws.]
- The OTS has adopted particularly stringent nondiscrimination rules, going well beyond the requirements of federal fair lending statutes.
- Even before release of the first HMDA data, the OCC had issued an Advisory letter urging banks to determine the reasons for racial and ethnic disparities in loan denial rates.
- Regulators have developed processes with HUD to share information on mortgage lending and cooperate in complaint investigations.
- Regulators have asked community groups, such as ACORN, to report instances of possible lending discrimination to the regulators.
- Through FFIEC, the regulators are contracting with a consultant to study and make recommendations for improving nondiscrimination examination procedures and training programs. (FFIEC = Federal Financial Institution Examination Council)
- The President's most recent appointment to the Federal Reserve Board, Larry Lindsay, has taken a key role in examining mortgage discrimination and has developed a range of interesting approaches to solving this problem.

The Bush Administration is fully committed to enforcing laws against discrimination in mortgage lending. In addition to the steps outlined above, the Bush Administration is working to ensure that the Community Reinvestment Act -- the law which prohibits "redlining" -- is vigorously enforced.

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<u>Dainesville</u>	<u>Phillip D. Brady</u>		
<u>GA</u>			

REMARKS:

Attached is the one page summary I received from Charles Kolb on housing discrimination.



NRN

Center for Strategic & International Studies
Washington, DC

ALL STAFF AND INTERNS ARE INVITED TO ATTEND

a press conference to release

CSIS's

"Presidential Transition Papers"

Monday, November 2, 1992
10:30 a.m., B-1 level

The Papers are a collection of 45 succinct 2-page assessments on the most immediate issues facing the next President and his transition team in the areas of foreign policy and process.

Each of the papers is written by a CSIS expert. They are organized in three categories--domestic, regional, and global--and span a wide variety of topics, including presidential priorities; defense and NSC restructuring; the drug challenge; Congressional reform; U.S. relations with the EC, Japan, China, the former Soviet Union, and Eastern Europe; the Arab-Israeli peace process; NAFTA; GATT; Cuba; Vietnam; and the global environment.

The Principal Speakers will be David Abshire, Robert Hunter and Erik Peterson.



United States
Global Strategy Council

Ed Boulware
Executive Assistant
to the Chairman

Good Luck!

1800 K Street, N.W., Suite 1102, Washington, D.C. 20006
Telephone: O: (202) 466-6029 Fax: (202) 331-0109
Home Mailing Address: P.O. Box 65346, Washington, D.C. 20006
H: (202) 547-8548



**United States
Global Strategy Council**

Washington Headquarters
1800 K Street, N.W., Suite 1102
Washington, D.C. 20006

92 OCT 27 AM 11:44

The Honorable James A. Baker III
Assistant to the President
and Chief of Staff
The White House
Washington, DC 20500

QMS # 61937

RUSH /

X-RAYED

THE
CENTER
FOR
SECURITY
POLICY

MRN

Date: 11/02/92

To: HON JAMES BAKER

Company:

Fax Phone Number: 94562883

CC:

From: CENTER FOR SECURITY POLICY

Subject:

of Pages (including this cover sheet): 5

Message:

General inquiries concerning the Center and name/fax number changes should be directed to Faye at extension 268 at the number below.

If you do not receive all pages, please call back immediately.

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THE
CENTER
FOR
SECURITY
POLICY

DECISION BRIEF
For Immediate Release

No. 92-D 136
2 November 1992
Contact: Jennifer W. Macdonald
(202) 466-0315

**SYRIA'S TERRORISM, HEGEMONY IN LEBANON
MAKES MOCKERY OF MIDEAST PEACE PROCESS¹**

(Washington, D.C.): If any proof were still needed, the despotic Syrian President Hafez Assad has demonstrated conclusively in recent weeks that — despite wishful thinking to the contrary in Washington and Jerusalem — he remains an unreliable negotiating partner and fundamentally committed to continued conflict with Israel. The Center for Security Policy believes that Assad's behavior in and towards Lebanon necessitates an urgent reassessment of U.S. policy toward Syria and a Middle East peace process which relies in large measure upon his constructive involvement.

This judgment is rooted in two related developments in Lebanon:

- (1) the increasing level of violent activity against Israel on the part of Lebanese-based terrorist organizations enjoying Syria's patronage or protection; and
- (2) Damascus' refusal to honor its commitments under the September 1989 Taif accords concerning respect for Lebanese sovereignty and redeployment of Syrian forces.

Syrian Support for Escalating Terrorism Against Israel

In the past two weeks alone, a slew of deadly assaults on Israeli citizens, communities and military personnel has been unleashed by several terrorist groups based in Lebanon and the West Bank. Responsibility for a number of the recent attacks was claimed by the radical Islamic group, Hezbollah, and the West Bank-based Hamas organization. Since Damascus has continued to permit Iranian weapons bound for these groups to transit Syrian territory and otherwise rendered support to them, Israeli Prime Minister Rabin has properly put Syria on notice that it is being held responsible for the resulting Israeli deaths.

The situation is likely to get much worse before it gets better. Recent political developments in Lebanon (about which more will be said in a moment) have placed *de jure* — as well as *de facto* — power in the hands of Syria's proxies. The new Speaker of the Lebanese Parliament, Nabih Berri, is the former commander of the Syrian-backed Amal, the largest Shi'ite militia in the country. Under the protection of Syrian troops and this new government, Syrian- and Iranian-allied terrorist rejectionist groups are expanding their operations in Lebanon. In addition, the Hezbollah has gained total control of the political apparatus in Southern Lebanon.

- more -

¹ This is the seventh in a series of Center for Security Policy *Decision Briefs* on the Bush Administration's misbegotten and potentially recklessly dangerous policy toward Hafez Assad's Syria.

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Center for Security Policy
Decision Brief

Page Two
2 November 1992

What is more, the various factions are undertaking renewed efforts to coordinate their campaign against Israel. On 12 October, Ahmad Jibril, head of the Syrian backed Popular Front for the Liberation of Palestine-General Command (PFLP-GC), Hezbollah deputy Ibrahim Amin Al-Sayyid and Husayn al-Musawi of the Islamic Amal Movement met in Lebanon to discuss the necessity of taking unified actions. Following the meeting, Jibril publicly emphasized the seriousness of the discussion and the fact that all sides agreed on everything.

Syria's strategic ally, Iran, has also forged a new working relationship with the Islamic fundamentalist Hamas. An early October trip by Hamas leader Musal Marzouq to Tcheran resulted in Iran's substantial backing for Hamas, including: a reported infusion of \$4 million into their coffers; the opening of a Hamas office in Iran; and establishment of bases in southern Lebanon to be used as staging areas for attacks against Israel. During that trip, Marzouq also met with leaders of the Hezbollah and representatives of the Syrian-backed PFLP-GC.

Finally, on 15 October, ten rejectionist groups wrapped up an important organizational meeting in Damascus. At the meeting four groups -- the PFLP-GC, Hamas, the Popular Front for the Liberation of Palestine, and the Democratic Front for the Liberation of Palestine -- drew up plans actively to oppose all elements of the peace process with terrorist actions. This was stated clearly in "Point 2" of the agreed "Plan of Action" which called for unity between the nationalist and Islamic forces in continuing the Intifada and in an "escalation of the *jihad* and armed struggle against the Zionist enemy."

Syria Reneges on the Taif Accords

If such hostile activity were not enough to dampen expectations of a genuine breakthrough in Israeli-Syrian relations, Damascus' failure to live up to its commitments under the internationally brokered Taif agreement should give serious pause to the Bush and Rabin administrations. As noted in a recent *Center Decision Brief*², Syria failed to withdraw its troops from all but the eastern Bekaa Valley by 22 September 1992 -- even though it was required to do so by the agreements negotiated three years before in Taif, Saudi Arabia. These agreements were reached under Arab League sponsorship and with the active support of the Bush Administration.

At the time, Damascus justified its non-compliance by pointing to the absence of a seated government in Lebanon. While elections had been held from 23 August through 7 September, the understandable refusal of Christian Lebanese to participate in the voting under Syrian-occupation prevented the polling from being truly "national." The predictable result -- namely, the triumph of Syrian- and Iranian-backed factions -- contributed to a delay in installing a new parliament and cabinet until well after the 22 September deadline for Syrian redeployment.

As of 22 October 1992, however -- with an elected parliament in place, the designation of one Syrian proxy (Nabih Berri) as its Speaker and the installation of another (Rafik al-Hariri) as

- more -

² See "Will Lebanon Ever Escape Syrian Imperialism? Don't Hold Your Breath!", No. 92-D 122, 2 October 1992.

Center for Security Policy
Decision Brief

Page Three
2 November 1992

Prime Minister -- even that stipulation had been satisfied. Yet, the government of Hafez Assad still refuses to fulfill its commitment to relinquish physical control over Lebanon. According to the Lebanese paper *Al Nahar*, Syria now insists that "other [unspecified] reforms" discussed in the Talf accord must be implemented before its forces are redeployed or withdrawn.

Lessons for Israel and Her Friends?

Syria's activities in Lebanon provide a timely reminder of the true character of the ruling regime in Damascus. After all, increased Syrian-sponsored terrorist activity against Israel and renegeing on its solemn international obligations coincide with intensifying pressure on Israel to concede some -- *if not all* -- of the strategic Golan Heights to Syria in exchange for a "peace accord."

The precedent and model cited for such a "land-for-peace" exchange, of course, are the Camp David accords pursuant to which Israel ceded the Sinai back to Egypt to secure a comprehensive peace agreement. Unfortunately, the similarity between the two situations is a superficial one. Due to their location (only 45 kilometers from Damascus) and topography (under Israeli control, the massif constitutes a virtually impassable barrier to Syrian armored attack and affords indispensable early warning), the Golan Heights are vastly more important for Israel's security than was the Sinai.

The near-loss during the 1973 Yom Kippur war of real estate with these critical attributes underscored the dangers of permitting a Syria still unreconciled to Israel's existence to regain control of the Heights. Unfortunately, contemporary behavior suggests that Hafez Assad is fully as committed to putting Israel at risk and no less unreliable a partner for peace today as he was in 1973.

The Bottom Line

The Center for Security Policy believes that it is an absolute travesty that the United States and other supporters of the Talf accords are now turning a blind eye toward Syria's continuing quest for political and military domination over Lebanon. Such Syrian behavior, combined with Damascus' continued support for international terrorism, demonstrates the futility of trying, as President Bush is wont to say, to bring Syria "into the family of nations" -- the rationale for previously coddling Saddam Hussein. Worse yet, it should serve as an unmistakable warning against relying upon Hafez Assad's word for anything, especially something as important and perishable as Israel's security.

No less unspeakable is the West's silence about the escalating violence from Syrian-supported terrorist groups against Israel. The inevitable effect is to embolden both the terrorists and their sponsors to believe that -- as long as the latter at least speaks occasionally of peace -- they can continue the armed struggle against Israel with whatever level of violence they chose, against whatever targets they chose.

Under the circumstances, it is incumbent upon the United States to revisit the premises upon which recent policies toward Syria have been predicated. Damascus must not

- more -

**Center for Security Policy
Decision Brief**

**Page Four
2 November 1992**

be permitted to sponsor attacks on Israel and abrogate at will its international commitments while continuing to enjoy the sorts of American largesse (including financial assistance, access to sensitive technology, political support and other benefits) documented in this Syria Watch series³. To do otherwise is to invite an even more dangerous repetition of the mistakes made by the Bush Administration toward Iraq.

Tomorrow's election provides an opportune moment for such a reassessment. Whoever the winner at the American polls, if future ties to Syria are not predicated on a cessation of Damascus' malevolent activities and fulfillment of its solemn obligations, the loser is sure to be U.S. long-term interests and the prospects for any genuine peace in the Middle East.

- 30 -

³ For a complete listing of the *Decision Briefs* in this series or copies of same, please contact the Center.

NRN

TEH-KUANG CHANG, Ph.D.
PROFESSOR OF POLITICAL SCIENCE, BALL STATE UNIVERSITY
CHAIRMAN OF RESEARCH COMMITTEE ON ASIAN POLITICAL STUDIES.
INTERNATIONAL POLITICAL SCIENCE ASSOCIATION

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317-289-5628 (H)

October 29, 1992

Mr. James Baker, Chief of Staff
The White House
Washington D.C. 20510
FAX: 202-456-6208

Dear Mr. Baker:

I was so glad to meet you on October 19, 1992 in the Radisson Hotel, in Lansing, Michigan, when we welcomed President Bush. I accompanied 60 College Republicans from Ball State University to go to Michigan to listen to the final Presidential debate and to rally for President Bush. I was so happy to greet President and Mrs. Bush in the hotel.

I thank you for your letter with your advice for the victory of Bush/Quayle '92. I made financial contributions to various Republican organizations according to my ability and I have strived to campaign for Bush/Quayle '92 with my responsibilities as Chairman of the Indiana State NRGH(N) Council Vice Chairman of the Midwest of National Republican Asian American Assembly, and Advisor of College Republicans at Ball State University. We completed the job with success for voters registration already. Because of the hard work of the College Republicans at Ball State University, about 1,000 people registered for the votes of Bush/Quayle. On October 27, we held a mock election prior to the election to stimulate the interests of the students and the community. There result was in favor of Bush/Quayle to be re-elected for 2nd term. The results of University Mock Election was spread by newspapers, radios, and television. That certainly will influence the public for your favor. The College Republicans have organized teams to make telephone calls to each voter to encourage them to vote on Election Day, November 3, 1992.

Enclosed, I am sending a newsclipping of our Mock Election of October 27, 1992 for your information.

With my best wishes for your continued success and good health.

Sincerely yours,

Teh Kuang Chang

Teh-Kuang Chang
Professor of Political Science

THE BALL STATE DAILY NEWS

WEDNESDAY, OCTOBER 28, 1992 • 1 SECTION, 8 PAGES

ESTABLISHED 1922 AS THE EASTERNER

VOLUME 72, NUMBER 47

Mock Winners

Student's mock vote recaptures election for Bush

By MARC KOVAC
News Editor

About 370 students showed up at Student Association's mock election sites Tuesday and voted George Bush and Dan Quayle back into office for a second term.

The incumbents received 46.7 percent of the total vote.

Bill Clinton and Al Gore received 36.6 percent while independents Ross Perot and John Stockdale received 15.1 percent of the vote.

Though only 173 students out of 20,000 participated in the six-hour poll, the SA director of governmental affairs was happy it was a service to students.

"I'm extremely satisfied (with the student turnout in the election)," said John Ray. "We were able to provide information to people. We may get them to vote when they may have not of before."

In addition to presidential candidates, student voters picked Democrats Evan Bayh and Frank O'Bannon for Indiana's governor and vice governor, Democrat Phil Sharp for an Indiana Congressional seat and Republican Dan Coats for an Indiana senatorial seat.

Ray said he hoped students would continue to be concerned about the upcoming election and take the time to visit the ballot box.

"Students that voted today seemed to be extremely excited about the election," he said. "I hope they keep that excitement next week and show up to the polls on Tuesday."

DECISION

An ongoing look at the election.

Mock election results

The following results are from Tuesday's mock election:

Voters: Male 248 Female 125

President and vice president of the United States

George Bush and Dan Quayle (R) 46.7% ✓

Bill Clinton and Albert Gore (D) 36.6%

Ross Perot and James Stockdale 15.1%

Andre Marrou and Nancy Lord 1.0%

Lenora B. Fulani and Maria E. Munoz .5%

United States senator

Daniel Coats (R) 69.6% ✓

Joseph Hogsett (D) 25.5%

Steve Dillon 4.1%

Raymond Tirado .8%

United States congress

Philip R. Sharp (D) 50.3%

William G. Frazier (R) 46.3%

Theodore Shaver 3.4%

Governor and lieutenant governor

Evan Bayh and Frank O'Bannon (D) 56.5%

Linley E. Pearson and Robert D. Green (R) 39.9%

Mary C. Barton and Elmetta Wellington 3.7%

Attorney general

Timothy L. Bookwalter (R) 59.8%

Pam Carter (D) 40.2%

Superintendent of public instruction

Suellen Reed (R) 60.8%

Stan Jones (D) 35.9%

Charles T. Knight 3.3%

State representative (District 35)

Bruce N. Munson (R) 60.9%

Patricia A. Eddy (D) 39.1%

County treasurer

Martha J. Lasater (R) 65.9%

Larry M. Brandon (D) 34.1%

County surveyor

Richard W. Thornburg 63.7%

James A. Petry 36.3%

County commissioner (District 1)

Richard J. Amburn (R) 60.4%

Robert Hartley (D) 39.6%

County commissioner (District 2)

George Schnuck (R) 59%

Robert C. Donati (D) 41%

Because of space limitations, county councilman and judicial results are not included.

Dr. & Mrs. Teh-Kuang Chang
1015 W. Wayne Street
Muncie, IN 47303 USA



MUNCIE IN 47303 10/31/92

Mr. James Baker, Chief of Staff
The White House
Washington, D.C. 20510

DIRECTORS

MORTGAGE LOAN CORPORATION

110 110th Ave. N. E., Suite 210
P.O. Box 4168, Bellevue, WA 98004
Office/Pager 451-8840 Fax 462-2984

Facsimile Transmission

Date: 11/2/92 Number of Pages following: 1

To: James Baker - Chief of Staff

Company: White House - Washington D.C. Fax Number: 1-202-456-2461

Attention: _____

Please direct any questions regarding this transmission to:

Name: Greg Franks / Regional Sales Manager - Directors Mortgage Loan Corp.
President - Puget Sound Mortgage Lenders Assoc.

Comments: _____

1-206-462-2742

MMN

PUGET SOUND MORTGAGE LENDERS ASSOCIATION, INC.
P.O. BOX 1845 TACOMA, WASHINGTON 98401

November 2, 1992

U.S. Department of Housing and Urban
Development
Washington, D.C., 20410-8000
Attn: Jack Kemp

Dear Mr. Kemp:

I recently read that you had announced a final regulation regarding HUD's position on RESPA and services provided by others including realtors in the financing of home mortgages. Basically you have approved kick-backs to realtors or others who provide little or no assistance to the consumer with regard to mortgage financing; or assistance that's previously been available at no charge.

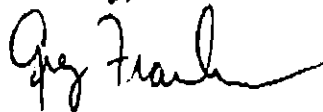
I can't stress enough how strongly our organization opposes this measure.

You are allowing, even encouraging unwarranted and unnecessary fees that will ultimately pass on to the consumers for services they currently receive, or loan information that is readily available.

This is the very form of padding that RESPA was enacted to prevent. Twenty years ago it was a common practice to slip the realtor a few dollars for the referral of customers to provide financing for. This referral for payment was common practice. The consumer ultimately paid additional fees, disclosed or not. It was wrong then and it's wrong now.

Two years ago your position was 180 degrees to this new election eve politics. Let's not allow this silliness to impact home borrowers for years to come.

Sincerely,



Greg Franks
President/Puget Sound Mortgage Lenders

cc: James Baker, White House Chief-of-Staff
George Bush, President of the United States

FAX Message

NRN

Date: 11/02/92

To: SAM SKINNER

Company:

Fax Phone Number: 1-202-456-2461

CC:

From: BILL RAY

Subject: THE MORTGAGE REPORT

of Pages (including this cover sheet): 2

Message:

If you do not receive all pages, please call back immediately.

Voice: 619/461-6310

Fax: 619/461-3417

Telex:

DATELINE: November 2, 1992

=====

30-YEAR FIXED RATE MORTGAGE PRICING

TODAY'S FHLMC AUCTION RESULTS:

08.45% street rate (auction price of 08.20% + .25% lender servicing costs), staying aloft for tomorrow's voter drive to the polls...

=====

SHORT-TERM TREND:

The long-term credit markets are hung up and out to dry awaiting tomorrow's election results. There will be some big-time movements downward if Bush pulls out a supriser, as the credit markets view Democrats in all Houses somewhat like the fox guarding the chicken coop of fiscal restraint.

=====

LOCK-IN ADVICE:

High anxiety over a Democrat victory cost the market over 1/2% in higher long-term rates, so its fair to say that all of this would be regained with a Bush upset victory (though dampened somewhat if Demos remain entrenched in Congress). Look for a slow erosion in long-term rates if Clinton gets the crown and if Congress wears the same old tax and spend faces...

=====

THERE'S A SIGN POST UP AHEAD: WRONG WAY

The road the Demos plan carries new sign posts: "PRO-BUSINESS, PRO-WORLD COMPETITION THIS WAY." So simple this roadway looks, it's like leisurely driving Miss Daisy. But if one were to stop and pull out the road map to verify the direction of this chauffeur-driven limo, voters might just hesitate when they see the " + " indicating the ill-fated wreckage of others who left all the driving up to government. Tucked away in the glove compartment lies an aged map book, with something scribbled on the inside cover-- "socialism: government ownership and administration of the means of production and distribution of goods." The chauffeur-driven voter, only concerned about getting to the polls and picking up his next pay check, chucks the map book and instructs the driver to continue down the road, missing the new sign-post that reads "GOVERNMENT ADMINISTRATION OF GOODS & SERVICES AHEAD ONE MILE" followed by "DEMOCRATS FOR CHANGE 1/4 MILE" and finally "DEMOCRAT VOTER BOOTH NEXT STOP". Voters will be taking a ride to the polls tomorrow, but many will be taken for a ride if they expect the Demos will guide them to a better economic world. Economics has never been a trademark of the Democratic Party. Sharing and redistributing the wealth is their trademark, passing the burdens of these programs on business or a new costly bureaucratic agency. Now the Demos want government to be in the driver's seat administering the goods and services of the health care industry, which is a full 13% of the U.S. economy. Not stopping there, they wish to guide and direct businesses to be better global competitors, but recent legislation passed by the Democratic House would have amounted to a head-on collision with this newly claimed direction. The legislation prohibited employers from replacing striking workers. How would a company compete globally and expect to survive if it is forced to pay whatever striking workers require? And what of the jobs lost if the company folded because of its inability to compete?

Why, Miss Daisy would be alarmed if she knew these government chauffeurs have neither any decent driving record nor even a license to drive on this precarious roadway (little did she realize that she's being driven to the polls to O.K. new driver licenses for these official-looking drivers). "Not to worry, Miss Daisy, theres another signpost up yonder. I can barely spell it out, maamm. Le' me put my spectacles on furst. Ya...it say ---T-H-E-T-W-I-L-I-G-H-T-Z-O-N-E..."

DISCOVER THE QUALITY IN ALTERNATIVE MORTGAGE FINANCING

AT MESA PACIFIC

CALL 619-461-6310

NPN

Dear National Republicans & Jim Baker:

Tomorrow the people will be voting and most of the people will be thinking about peace and our ability to grow and develop properly with peace.

It is George Bush that helped change the world towards a more peaceful and sane world; devoted to commerce and industry.

Although this was never stressed enough; this is the key and always has been the ~~key~~ to winning elections in this century. The people want peace and prosperity.

The people also want ideals and George Bush has provided this nation with ideals for a better world order; and quietly the millions have appreciated these ideals.

A challenge was made 2,000 years ago for "he who is without sin" to cast the first stone; and so we may have lost a lot of ground with the more baser approach to winning elections.

The contest tomorrow will essentially show whether the higher ground campaign had won out over the old "holier than thou" anger that was mustered from the convention and the earlier stages of the campaign.

The Republican Party has always been a great ally of business and commerce; which the long history of our Republic has shown abundantly.

The Republican government of Lincoln gave land to the railroads and land, up to 160 acres; free to those who would farm the land. This was 1800's government investment. Let us not contradict the great Lincoln therefore and declare "The government doesn't invest..." The United States government under Republican Presidents and Republican Congresses also gave ~~one~~ trillion dollars in monies to the airplane industry to develop the airplane for war and peace.

The government has invested in airports and roads and multiple pioneering technologies. Let us not become ignorant of history.

We need to upgrade our standard for conducting elections; and, ~~the truth~~ is the ally of all who would do good as was noted by the ancient Socrates and the prophets.

Let us hope that ~~the best in Republican traditions~~ wins out in the minds of the electorate and let us note that much more could have been done to cultivate this great and noble ~~Republican legacy~~.

Let us sincerely hope that the people remember the great deeds of President Bush in making it possible for our nation to focus on industrial and commercial development; our standard of living! So much was done to obscure these deeds that our hope that the deeds were brighter than the obscuring; and that victory will be won tomorrow.

George S. Tolmie
election eve 1992
Lincoln Republican

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5105236746 FRB TDRN ALAMEDA CA 458 11-02 0428P EST
PMS JAMES BAKER III AND PRESIDENT GEORGE BUSH, DLR
WHITE HOUSE

NEW
92 NOV 3 AIO: 18

REROUTE OF 1-002102S307

SIRS,

CANDIDATES PEROT, CLINTON, PRESIDENT BUSH AND THE DEMOCRATIC CONGRESS HAVE NOT MADE CLEAR CAUSE OF ECONOMIC PROBLEMS TO OLD AND YOUNG CITIZEN VOTERS BECAUSE ALL SHARE SUPPORT OF FREE TRADE, A VERY FAULTY THEORY THE ANGER AND BLAME MISDIRECTED TOWARD YOU. YOU MUST ENLIGHTEN THE VOTER. BECAUSE OF CONTINUAL PLANT CLOSINGS AND JOB LOSSES THE INSTANT GENERATION WILL NOT WAIT ANOTHER 15 YEARS REVERSE COURSE IMMEDIATELY NOW. IMPERATIVE PRESIDENT BUSH TELL VOTERS THAT HE WILL AGREE TO SLAP ON AND OFF AT ENTRY THROUGH DEPARTMENT OF COMMERCE A TARIFF-DUTY-TAX UNTIL AMERICA IS STRONG IN THE WORLD AGAIN. NO BIG DEAL, NO WAFFLING, JUST COMMON SENSE BUSINESS TO SAVE THE DAY, AS MY GENIUS FATHER DID IN 1929 CRASH, SAME WORLD

PROBLEM OF JAPAN DUMPING ON HIS SOUTH SAN FRANCISCO E H EDWARDS
78 YEAR OLD STEEL WIRE ROPE SMALL BUSINESS COMPANY AND BIG
BUSINESS LABOR COSTS OF COMMENSURATE LABOR COSTS OF \$32.00
AN HOUR WITH BENEFITS VERSUS JAPAN'S SUBSIDIZED LABOR COSTS
OF \$0.22 PER HOUR IN COMPETITION WITH AND AGAINST EDWARDS
200 EMPLOYEES 125 OF WHOM WERE AFL-CIO BIG STEEL UNION WORKERS. AMERICA
HAD UNPRECEDENTED PROSPERITY AND PROFITS FOR 30 YEARS BETWEEN
1933-1963 UNTIL JAPAN CAME BACK AFTER A WAR AT PEARL HARBOR
AND WORLD WAR II INTO SAN FRANCISCO'S AFTERMATH 20 YEARS LATER
AT THE SAME COMMENSURATE JAPANESE \$0.22 AN HOUR AGAIN FOR
THE NEXT 14 YEARS WHICH DECIMATED OUR UNITED STATES SMALL
BUSINESS AGAIN THIS TIME WINNING THE ECONOMIC WAR IN 1977 WITH
DISAPPEARANCE OF EDWARDS CO AND SMALL BUSINESS. UNDER PRESIDENT
CARTER IN 1977 EDWARDS FORCED TO ENTER CHAPTER 11 LOSING ALL
OUR 9 ACRES OF LAND, 7 ACRES UNDER ROOF, ALL MACHINERY, SAN
FRANCISCO MILL, BRANCHES: HOUSTON, PORTLAND, SEATTLE, LOS
ANGELES, ALASKA AND HAWAII, ALL INVESTMENTS AND CASH. EDWARDS
HAS NOTHING BUT THE NAME LEFT AND THE RECORDS I SAVED. EDWARDS
QUALITY THE FINEST ROPE MANUFACTURED IN THE WORLD AT THE LOWEST
PRICE. JAPAN COULDN'T TEACH US A THING. JAPAN STOLE ALL OUR
IDEAS FROM VISITS AFTER PEARL HARBOR TO OUR MILL IN SOUTH SAN
FRANCISCO, AND FROM OUR BROCHURES. THERE IS JUST ANGER FROM
THE AMERICAN PEOPLE AND NO JUSTICE, THEY ARE BLAMING YOU WRONGLY.
SOLUTION, SMALL BUSINESS ALONG WITH BIG BUSINESS DOES ERADICATE
POVERTY. IT ELIMINATED POVERTY BEFORE AND IT WILL ELIMINATE
POVERTY AGAIN, THIS IS THE SECRET AND THE SOLUTION TO THE
WHOLE PROBLEM. THAT IS ALL. I HOPE WITH ALL MY HEART YOU GET

THIS MESSAGE OVER IN TIME TO WIN THE ELECTION BECAUSE IT IS
THE ONLY THING THAT WILL WIN THE ELECTION FOR PRESIDENT BUSH.
SENATOR REIGLE'S HOPING THAT YOU WILL FORGET THIS FACT AND
WILL GO TO SLEEP OVER DUMPING, I CANNOT. GOD IS WITH YOU IS
HE NOT ALL THE WAY? YES HE IS.

CYNTHIA EDWARDS WILLIAMS
(MRS) KERMIT L SR

1019 EST

IPMWHD1 WSH

[illegible]

CHURCHILL
JOSÉ L. MAS CANOSA
VICE CHAIRMAN
ALBERTO M. FERNANDEZ M.D.
PRESIDENT
FALGOUTO J. FERNANDEZ
TREASURER
101 KRANTZ FOTO, S. P. A.
SECRETARY
TONY COSTA

central files

cf gave a copy
fyi to Rose
Zemaria.

DATE: 11-3-92

TO: The Honorable James A. Baker III

The White House

FROM: Mr. Jorge L. Mas

PAGES TO FOLLOW: 2 NOT INCLUDING THIS PAGE

NOTES:

MIAMI: P.O. BOX 440069 / MIAMI, FLORIDA 33144 / TEL.: (305) 592-7768 / FAX: (305) 592-7819
WASHINGTON: 1000 THOMAS JEFFERSON STREET N.W., SUITE 601 / WASHINGTON, D.C. 20007 / TEL.: (202) 265-2822



CHAIRMAN
JIMMY L. MAS CANOIA
VICE-CHAIRMAN
ALBERTO M. HERNANDEZ M.D.
PRESIDENT
FRANCISCO J. HERNANDEZ
TREASURER
JELICIANO TOYO L. P.A.
SECRETARY
TOMMY COSTA

The Honorable James A. Baker III
The White House
1600 Pennsylvania Avenue, N.W.
Washington, D.C. 20500

Dear Secretary Baker:

The Cuban American community has long admired the Bush Administration's leadership and commitment throughout the years on behalf of a free and democratic Cuba.

The people of Cuba, those on the island and in exile, are grateful for President Bush's call for liberty and justice in our native homeland and for all he has done for the cause of human rights and self determination for the Cuban people.

For this reason, I am writing to you in hopes of shedding some light on my recent meeting with Governor Clinton in Tampa, as it appears many in the press have chosen to mischaracterize the nature and purpose of that meeting, as well as my personal position on the Presidential election.

As you know, since 1980 the Cuban American National Foundation has worked to promote liberty for Cuba and has labored endlessly to enlighten policy makers, academicians, and world leaders on the Cuban people's struggle against Castro's tyranny.

The Foundation is a non-partisan organization and, as such, could not reject the Democratic Party Presidential nominee's invitation to discuss the issue of Cuba. As a Cuban exile, as as Chairman of the Foundation, it is my duty and responsibility to meet with those who embrace our cause as Governor Clinton has done.

Please understand and be assured, however, that I remain personally committed to President Bush. I have made it clear to the press and to all concerned parties that my meeting does not constitute an endorsement of Governor Clinton as the Foundation is not in the business of endorsing candidates. On every possible occasion, I have publicly and privately reiterated my

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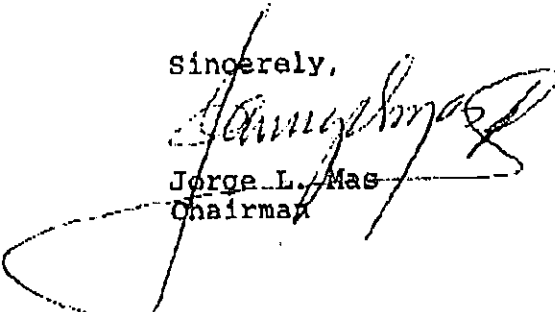
Page - 2 -

personal friendship and loyalty to the President, and have appeared on numerous interviews and programs to express my support for his reelection to a second term.

It is unfortunate that some members of the press, for their own interests, have tried to portray this meeting in a different light and have sought to play politics with this painful and sensitive issue while ignoring the suffering and oppression endured by our brothers and sisters who remain enslaved in Cuba.

We are a loyal and grateful people who recognize all that you, the President, and his Administration have done to realize our dream of bringing a new age of freedom to our homeland. I hope that you will let President Bush know of our sentiments and trust that we will soon be able to greet him again in Miami and personally thank him for his friendship. Until then, please accept my warmest personal regards and best wishes.

Sincerely,



Jorge L. Mas
Chairman

LAW OFFICES

TIMOTHY D. NAEGELE
& ASSOCIATES

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Los Angeles, California 90067
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Washington, D.C. 20037
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202/466-3079 (WDC)
310/457-4014 (LA)

November 2, 1992

By Fax and By Mail

Mr. Robert B. Zoellick
Deputy Chief of Staff
The White House
Washington, D.C. 20500

Dear Mr. Zoellick:

You and Secretary Baker -- and of course the President -- are doing a great job! Victory is in sight! I get a real sense of positive momentum. As I travel and talk with people in various parts of the country, I find that many fence-sitters will be voting for the President tomorrow and there's a growing feeling that he will win both the popular vote and the electoral college. Something wonderful is happening!

Someone should get the word out that Bill Clinton's credentials as a candidate are all set out in the December issue of Penthouse which is at the newsstands now. I was in San Francisco on Thursday and a client brought it to my attention. The President is right: the guy is a bozo and the Penthouse article makes that clear. It's enough to have "Governor Sleaze"; the idea that people would vote for "President Sleaze" is outlandish.

Good luck!

With kindest regards,



Timothy D. Naegle

TDN/bf

Central Files

I sent you a copy of this earlier,
which we had received by FAX.
NRN

Cozetta 2533 11/3

NRN

MARSHALL T. MAYS
Post Office Box 951
Pawleys Island, S.C. 29585
(803) 237-8523*

Nov. 4, 1992

Mr. James A. Baker, III
Chief of Staff
The White House fax 202-456-2883
Washington, D.C.

Two Months of Opportunities

Dear Jim:

You and your team made a valiant effort and we thank you for it. Please consider the feasibility of a new peace effort in the Middle East in conjunction with the President-Elect, and his personal representatives President Carter and Ambassador Andrew Young.

Invite the Middle East parties to Camp David to meet President Bush and President Carter on November 16. Invite Henry Kissinger as a representative of Presidents Nixon and Ford. You and Warren Christopher can orchestrate the event. Speed and surprise are on your side. This may be an historic Opportunity.

Call for three days of prayer, Friday, Saturday, and Sunday, before the meeting, with due respect for President Sadat and his contribution to the peace process.

Israel and Kuwait together could lead a new economic development program for the entire area. The opportunity blows my mind.

Please convey my highest regards to President Bush.

Sincerely,
Marshall

Gustaf Silfverstolpe
B.A. M.B.A.

Lund, Sweden, Nov 4th, 1992

NRN

Secretary James A. Baker
The White House
Washington
USA

URGENT!

Re: Angola

Dear Mr. Baker,

Please help UNITA now, they need your help in this very moment.

Please, Mr. Baker, engage yourself in the critical situation in Angola. Your immediate help is of greatest importance.

++++++

Please also talk with Mr. Herman Cohen. He is disastrous for peace and democracy in Angola. He sides too much with the opinion of the MPLA. What Mr. Cohen says pleases the MPLA and is terrible to listen to for UNITA and anyone who wants fair play and democracy in Angola. He made a horrible interview on BBC World Service, Monday Nov 2nd at 21.10 GMT. It was very painful to listen to an American with so little understanding of the situation in Angola. With the views he expressed he is a gravedigger for fair play and democracy in Angola. Please release Mr. Cohen immediately.

+++++

Once again, Mr. Baker, please engage yourself immediately in the critical situation in Angola.

Yours faithfully,

Gustaf Silfverstolpe
Gustaf Silfverstolpe

Enclosing 2 letters, which
I faxed to you on Oct 2nd
and Oct 22nd.

Lilla Fiskaregatan 12, S-222 22 Lund, Sweden
Tel +46-46-16 09 00, Fax +46-46-12 87 92

Lund, Sweden, Oct 6th, 1992

Secretary James A Baker
The White House
Washington
USA

URGENT!

Dear Mr Baker,

First of all I would like to thank you profoundly for all that you have done for peace and democracy in many parts of the world. Your leadership on many sceens of the world will be long remembered; US-Soviet relations, the crisis in the Gulf incl. the thrilling debate and vote in the UN Security Council, efforts for peace in the Middle East etc. It is a great pitty that you are not longer active as Foreign Secretary of the United States. Hopefully you will be back in that position soon. You are really needed.

The reason for this letter to you is Angola. Thank you for all your efforts which resulted in the peace accord in Lisbon in May last year. However, I think Angola needs your immediate help now.

UNITA leader Jonas Savimbi and his staff are convinced that there was fraud in the elections in Angola last week and in the election results presented. UNITA demands a review of the election results.

Please, mr Baker, use your strong political weight and reputation to put pressure on the MPLA government so that really correct results from the elections can be established or the election results be declared non valid and new elections has to be accomplished. Please also put pressure on the UN representative not to accept election results if the are not to 98%, or still better to 100% correct.

Yours very faithfully,



Gustaf Silfverstolpe
H.B.A.

Adress:
Lilla Fiskaregatan 12
S-222 22 Lund, Sweden

Tel: 046-160900

Fax: 046-128792

fax kl. 16.30 - OK

Lund, Sweden, Oct 22nd, 1992

Secretary James A. Baker
The White House
Washington
USA

6 pages incl. this.

incl. 3 pages {The Washington Times 19/10
The Wall Street Journal 21/10}

Dear Mr. Baker,

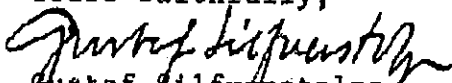
Sending you a copy, for your information, of a fax-letter to the Editor of The Washington Times, in which I mention you.

Sending you also of a fax-letter I sent to you on Oct 6th. I think that you would be the best person to help Angola now.

Please also talk with Mr. Herman Cohen. I am convinced that he is negative for the solving of the serious crisis in Angola. He make statements which irritates UNITA. Probabely it is Mr. Herman Cohen, who is referred to in The Wall Street Journal, Oct 21st, in an article bearing the head line: "Only Fair Elections Can Keep Angola's Peace": - "A high-level State Department spokesman, testifying before the U.S. Congress on Oct. 8, said he told UNITA's Mr. Savimbi to "stop saying the election was fraudulent." This statement undercuts the important work of the U.N. investigatory team."

Understand my sister in Belgium, comtesse Elisabeth de Lalaing, is in contact with some of your staff in the White House, on an other project.

Yours faithfully,


Gustaf Silfverstolpe
M.B.A.

Address:
Lilla Fiskaregatan 12
S-222 22 Lund, Sweden

Tel: 046-160900

Fax: 046-128792

ATTN: RECEIVER

8426 Stable Drive
Alexandria, VA
(703) 780-2439
October 27, 1992

TO: THE CHIEF OF STAFF
THE WHITE HOUSE

I HOPE THAT THIS LETTER CAN BE FAXED TO PRESIDENT
BUSH, OR TO SOMEONE THAT CAN SHOW IT TO HIM.

The President
The White House

THANK YOU

NON

H. B. B. B. B.

Dear Mr. President:

In the closing days of the campaign, here are some suggestions that might turn some voters to our side.

First, to be effective, a way must be found to get Governor Clinton on national television and get his replies to the following two questions on the air: Question number one: "Are you familiar with the 'Monroe Doctrine'?" as most Americans learned it in school, "My nation, in its intercourse with other nations, be it right or wrong, it is still my nation." Governor Clinton protested America's action in Vietnam, even though President Johnson and our Congress sent our troops there. Governor Clinton did not support his country.

The second question: "During the Vietnam conflict, what two countries backed the North Vietnamese?" As a college student and a Rhodes scholar, Bill Clinton should have known that it was communist China and communist Russia. Russia was the largest supplier of arms, guns, tanks, and planes to the North Vietnamese - war materials that killed over 50,000 American men. Yet, Governor Clinton saw fit to visit Russia as a college student during the Vietnam conflict. Russia at that time was indirectly fighting us, so it must have been some comfort to the enemy. Governor Clinton has told us that about 60,000 tourists visited Russia at that time. The answer to that statement is that 59,999 of these tourists are not running for the highest office in our land.

This might help on Perot. He is not qualified to be our president. I think that he is trying to buy the office, even if it costs \$1,000,000.00! He lied when he dropped out of the race in July. At the time he dropped out, on TV, he told his supporters to continue to get signatures to put him on the ballots of all 50 states. Does that sound like someone that is dropping out?

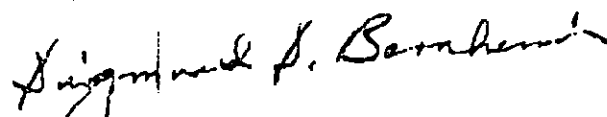
October 27, 1992

Page 2

On the above information, I suggest that you, President Bush, not personally get involved. Have someone like Mr. Fitzwater or Senator Dole go into action, or a newsperson - TV or newspaper - that can be trusted.

I hope that November 3rd will be four more years.

Respectfully yours,



Sigmund S. Bernheimer