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Briefing Paper
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BACK TO INVESTMENT

A Proposal to Create a Capital Investment Fund

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Introduction

On its present course the U.S. economy will not generate enough investment to reverse the nation's long-term decline in real wages. Even if we accept the current optimistic assumption that steady growth will continue for the next decade, public and private investment will fall hundreds of billions of dollars short of what is needed to support a high-wage future for the majority of America's working families.

In the 1980s, consumer spending was stimulated by expanding government debt. Today it is driven by lower interest rates. Even given the recent surge in business investment, this recovery is still best characterized as consumer led. It is appropriate to raise consumer spending in order to create jobs in times of excessive unemployment, but this strategy by itself cannot maintain rising incomes in a fiercely competitive global economy. A high-wage strategy requires a high rate of growth in both public and private capital investment.

To begin to meet that need, the federal government should immediately raise its annual level of investment in education, training, and public infrastructure by at least $40 billion. Given the current political climate, these expenditures should be paid for by a stream of dedicated, progressive taxes. Such a public investment increase would, in turn, stimulate billions in additional private capital spending per year.

Growth and Jobs Outlook

The economy has just emerged from a long recession in which average annual growth, from 1989 to 1992, was only 1%. Even if we make the conservative assumption that the economy's *potential* growth rate is 2.5% per year, it is clear that a significant gap has accrued between potential and actual gross domestic product. To recoup the lost ground, the economy will have to grow at a rate in excess of

2.5% over a sustained period. With the Congressional Budget Office projecting real GDP growth of only 252.9% through 1999, the economy still will not have returned to its potential level of output by the end of the century. The output lost as a result of this sluggish growth will total at least half a trillion dollars.

Moreover, there are reasons to believe that even these modest growth projections, driven by a significant upturn in consumer spending and a small increase in business investment, are optimistic. While consumption has grown strongly over the last year, incomes have not, and thus savings rates have fallen to record lows. Since consumption growth is unlikely to continue to outstrip income growth, we can expect the growth in consumption to slacken in the near future.

Help is not likely to come from the public sector. Growth in the federal government sector is being held down by design. In addition, the weak fiscal situations of state and local governments, coupled with further reductions in federal support, ensure that state and local spending will advance only minimally over the next several years.

The picture in the export sector looks no better. For every dollar in GDP growth, imports now rise by roughly 20 cents. The trade deficit therefore automatically increases as the economy expands, unless exports accelerate. But with minimal growth expected in Europe and Japan in 1994 and 1995, this is an unlikely short-term scenario.

At current growth rates the U.S. economy will generate approximately 1.8 million jobs per year, enough to absorb new entrants into the labor force but not enough to accommodate the backlog of unemployed or discouraged workers attributable to the recession. CBO estimates that, at this rate of job generation, unemployment in 1999 will still exceed its pre-recession level.

There is little in these numbers to suggest that the long trend of declining real wages will be reversed. In 1993, hourly wages again failed to keep pace with inflation, in part because there were few sectors of the economy where workers enjoyed any significant increase in real wages, and in part because employment continues to shift from relatively high-wage sectors like manufacturing to low-wage service-sector jobs. Throughout the recovery, over 60% of the new jobs created have been in either health care, restaurants, or temporary employment agencies. Unless this pattern of job creation is reversed, there will be a continued deterioration in wages and job quality, and continued anxiety among many middle-income working families.

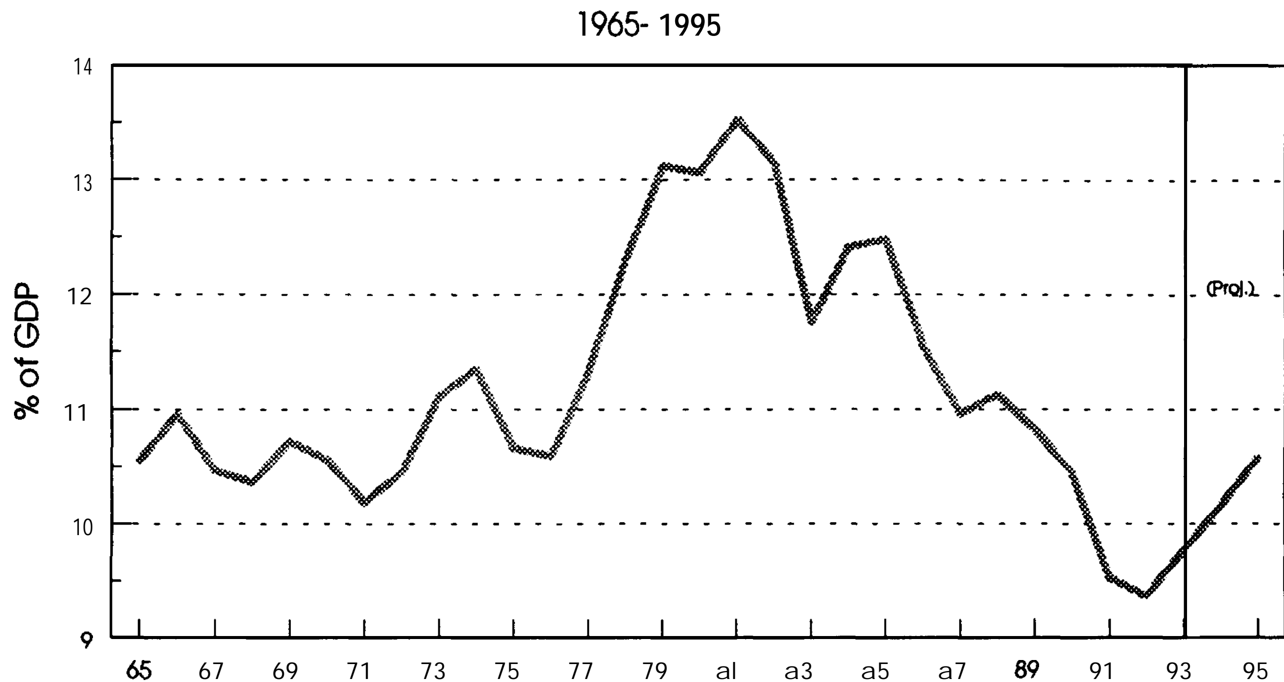
Private Investment Still Unsatisfactory

The official GDP reports show 14.7% growth in investment over the last year, but this rise was largely driven by the distorting effect of the way the Commerce Department estimates computer production. (In effect, a computer made in 1993 is counted at several times its current purchase price, since it would have cost far more to produce a comparable computer in 1987.) Taking this distortion out of the numbers, we find that private investment is now only 6% above its pre-recession level, as

Figure 1

Thirty Years of Private Investment

1965- 1995



Note: Data reflect **fixed**, non-residential investment in current dollars.
Sources: Historical data, CEA, 1993; Projections, Merrill Lynch, 1994.

opposed to the **15-20%** we should expect at this stage of the business cycle. Looked at another way-as a percent of GDP-private investment has yet to reach its pre-recession level (Figure 1).

The weak growth in investment should not be surprising. A recent study by Steve Fazzari for the Economic Policy Institute showed that investment is primarily determined by sales growth and the cash flow of **firms**. The recent fall in interest rates has undoubtedly had some positive impact on investment, both directly in lowering the cost of borrowing and indirectly by increasing **firms'** cash flow, but it was not nearly enough to offset the negative impact of slow overall economic growth. In general, **firms** still find themselves operating well below capacity, and they consequently feel little need to undertake major new investments.

Public Investment Gap

The slowdown in economic growth, combined with federal budget constraints, have weakened public investment as well. Five years ago, a group of over 300 American economists-including six

Nobel Prize winners and two-thirds of the current Council of Economic Advisors-signed a joint statement declaring that the current level of public investment was insufficient. The resulting public investment deficit, they said, "will have a crippling effect on America's future competitiveness."

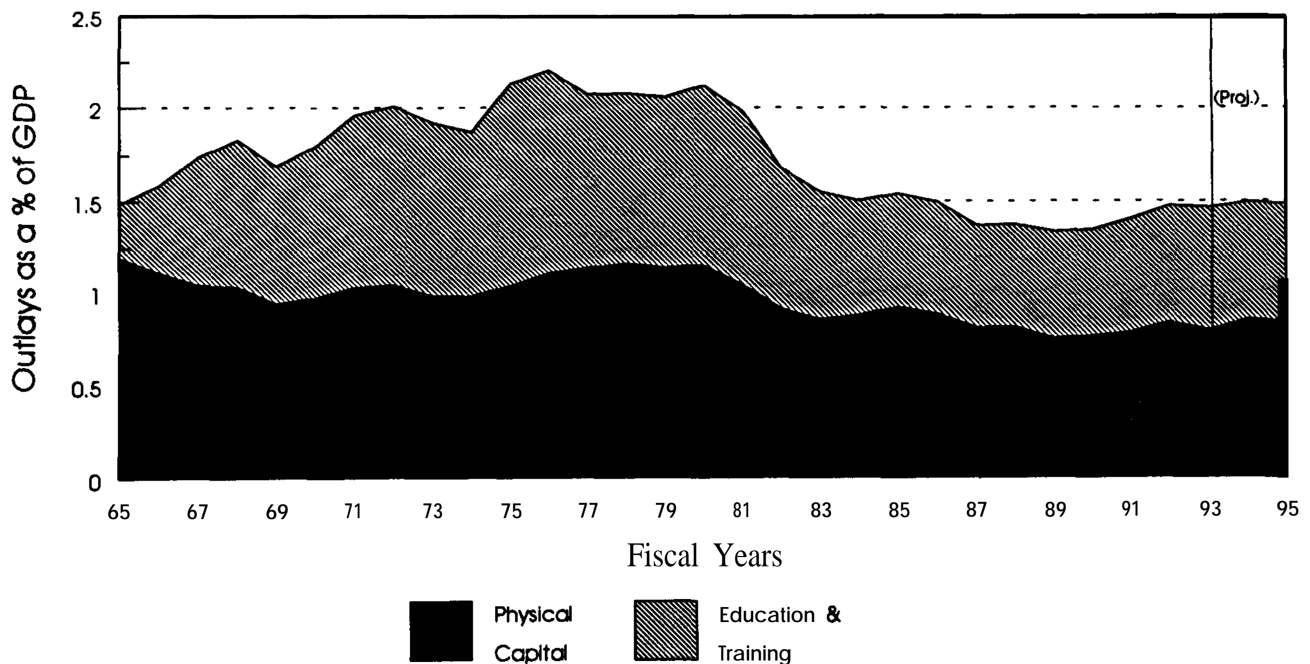
After the publication of that letter, and following eight years of cuts during the Reagan administration, federal investment began to rise. (Figure 2) Between 1989 and 1993, investment in physical and human capital grew by about $12 billion in real terms, to 1.5% of GDP (as compared to 2.1% in 1980 and 1.3% in 1989).[1] But investment has once again fallen victim to budget austerity. In 1994 and 1995, spending on public investment will be nearly stagnant, barely keeping up with the growth of the economy. By 1995, federal investment will still stand at only 1.5% of GDP, approximately one quarter less than it was in 1980. To return to the investment level of 1980, the year before the decade-long decline in investment, would require $40 billion in additional capital spending in FY95.

Another comparison of the investment gap can be made by looking at the budgets of our international competitors. Unfortunately, the finding is the same: as we have reinvested less in our

Figure 2

Thirty Years of Federal Investment

19651995



Source: EPI analysis of OMB data. 1994.

economic future, our major competitors have continually reinvested more. Consider annual spending for public physical infrastructure: in the 1980s, while the United States was spending 1.6% of GDP on infrastructure, Germany was spending 4.4% and Japan 6.3% (Bank for International Settlements 1991). To achieve even the level of Germany, U.S. investment in public physical capital alone-not counting education and training-would have to increase by $175 ***billion annually.***

International comparisons on the human capital side reflect a similar shortfall. For example, the United States ranks 18th out of 21 industrialized countries in public expenditures for labor-market training' (OECD 1993). To reach the median level of expenditure of countries surveyed by the Organisation for Economic Co-operation and Development, annual public sector outlays in the United States would need to increase by $15 billion. Given the higher level of spending on training in the private sector in most of these countries, the overall U.S. shortfall is even greater than the public sector numbers suggest.

Still another way to assess the investment gap is on a sector-by-sector basis. In 1991, an EPI study (Faux and Schafer 1991), drawing from a range of expert analyses of unmet needs in specific sectors, concluded that the investment gap ranged from $46 billion to $100 billion. The lower figure reflects the annual increase needed to prevent a continually widening gap; the higher figure reflects the increase needed to begin to address the backlog of unmet needs. A rough update of that study, accounting for the relative increase in federal investment spending of the last few years and incorporating new needs estimates, still places the minimum annual "investment gap" at about $43 billion.

Thus, using the smallest estimate of the gap, at ***least*** an additional $40 billion is needed annually just to prevent further erosion in the nation's public capital stock. To begin to address the growing backlog of needs, however, much larger sums-roughly double-are required. And the slower we are to begin such an investment program, the more expensive catching up becomes.

Capital Investment Fund

There is little disagreement that the United States is underinvesting in its human and physical capital. But the accepted wisdom is that first we must reduce the government's fiscal deficit. As a result, the current budget agreement puts rigid caps on domestic discretionary spending-the source of federal investment-until 1998. But even with that agreement the CBO estimates that in 2004 the deficit will take the same share of GDP it does now. Thus, the logic of our current budget policy condemns the U.S. economy to stagnant levels of public investmentfor at ***least the next 10 years.***

Moreover, if we accept the Administration's growth assumptions, the economy should be operating at somewhere near full capacity 10 years from now, with relatively tight labor markets and rising interest rates. Thus, the more we delay, the more danger there is that when we finally expand public investment it will crowd out private investment and be more expensive to finance. As any

business understands, the best time to launch a capital investment program is when there is excess capacity. In other words, a good time is now.

It is tempting to think that funds for new investment can be squeezed out of existing programs, that is, by "cutting and spending." Yet while there is clearly room in the federal budget to shift priorities, there is enormous disagreement over how to do so. Holding needed new investments hostage to a rearrangement of priorities at a detailed level of the budget is in effect a decision not to make the necessary expansion of investments.

At the same time, given the current political climate, any strategy to expand investment must recognize the political constraints imposed by the deficit. The most sensible framework for resolving the investment question in a time of a budget squeeze is to apply conventional rules of business accounting to the federal budget. Specifically, that would mean dividing the budget into separate capital and operating accounts. The operating budget would in all years be kept in balance or surplus, while the capital budget would consist of investments financed with a combination of cash outlays and borrowing amortized over a long period. This kind of bookkeeping would permit the government to maintain its financial integrity today without skimping on investing for tomorrow.

Although there is wide support for this concept, it will clearly take time before Congress is ready for such common-sense accounting. We can take a first step in the meantime, however, by establishing a Capital Investment Fund to finance investment the country needs now. This fund, maintained off-budget and self-financing, would raise dedicated revenues in a progressive manner and fund investment programs to rebuild our physical and human infrastructure for the next generation.

Despite our resistance to taxes in general, Americans seem willing to pay higher taxes for specific government activities they consider necessary. For example, a mid-October Harris Poll surveyed the willingness of voters to pay higher taxes to fund various federal initiatives. Not surprisingly, voters' willingness to endure tax hikes varied widely depending on the activity to be funded. In fact, the most popular purpose—creating jobs-found only 9% of voters "not at all willing" to absorb a tax increase. We believe that the purpose described here-investment-would prompt similar sentiment.

The proposed Capital Investment Fund would be divided into two parts, physical capital and human capital, each with a dedicated funding stream.

Physical Capital

Based on the widely accepted tradition of financing physical capital investments over the life of the capital, the physical capital portion of the Fund would function like an investment bank, such as that advocated by financier Felix Rohatyn and former New York City Finance Commissioner Carol O'Cleireacain.

Table 1
CAPITAL INVESTMENT FUND
(Billions of 1994 Dollars)

	Years 1-10	Years 11-40
Physical capital (per year)	25	0
Financing costs (per year)	10	10
Human capital(per year)	15	15
Financing costs (per year)	15	15
Total New Investment per Year	40	15

Under this system, the federal government would:

- Create an off-budget fund with a fixed, long-term, dedicated funding stream.
- Undertake a major capital improvement program over a shorter period to be financed by the fund.

This arrangement would permit a much-needed investment catch-up effort within the confines of fiscal austerity. Over the life of the bank, the program would pay for itself, including interest.

We recommend creating a ***40-year*** bank financed either with a gradual increase in the gasoline tax (as advocated by Rohatyn) or by limiting the tax benefit of itemized deductions in the personal income tax. The former has the advantage of mirroring the current funding method of the Highway Trust Fund; the latter is far more progressive. Whatever the financing mechanism, this dedicated funding would generate about $10 billion per year.

The fund would allow the government to undertake a serious ***IO-year*** physical capital improvement program of about $25 billion per year, the minimum needed to begin to address the nation's growing backlog of capital investment needs.

Human Capital

Based on an update of our 1991 needs estimate, we recommend $15 billion per year for human capital investment. Roughly two-thirds of that sum would be earmarked for the nation's public education system, including full funding for Head Start and equalization payments to poor school districts. On the training side, roughly $5 billion is needed to begin to adequately finance the President's Workforce Security Act.[3]

Investment in human capital could be paid for with a small tax on financial transactions. Such a tax would have the added benefit of discouraging speculative transactions and reducing market volatility. It would also be highly progressive, since the vast majority of revenues would be drawn from those at the top end of the income distribution.

A 0.25% tax on all stock transactions, for example, with an appropriately weighted tax applied to bonds, options, futures, currency swaps, and other financial instruments, would raise in excess of $30 billion per year with little impact on the normal functioning of the financial markets. Transactions costs on the major stock exchanges have fallen rapidly over the last 20 years. So even assuming that the full cost of the tax is passed on to consumers, it would raise average transactions costs only to their 1982 levels.

Economic Benefits

The program outlined above would have important positive ramifications for the economy. First, economic growth would increase by approximately 0.5% in the first year (1995), 0.3% in 1996, 0.1% in 1997, and 0.15% in each subsequent year. Beginning in about the eighth year of the program, productivity growth would increase approximately 0.15% more than it would have without the added investment. This productivity growth would support rising real wages.

In the first year, employment should increase by about 400,000 jobs. Thereafter, job growth will be little affected, although the higher levels (and lower levels of unemployment) will be maintained.

Finally, because of the improvements to the overall economy, revenues would be enhanced and cyclical outlays reduced, resulting in an improving deficit picture. These economic effects would lower the deficit by about $7 billion in the first year, $10 billion in the second, and $25 billion in the 10th.

Conclusion

In the campaign of 1992, candidate Clinton rightly called for reversing the long-term trend in which Americans have been working harder for less. This goal cannot be achieved without adding a minimum of $40 billion to annual public capital spending. However, it is impossible to finance that level of investment in the framework of last year's budget agreement. In the absence of a capital budget, a dedicated investment fund is a fiscally responsible way to modify that agreement to permit more capital spending. Failure to raise and sustain higher investment spending is a virtual guarantee that real wages in America will continue to decline.

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Endnotes

1. This includes federal spending on highways, bridges, airports, rail, and other physical capital, as well as spending on education and training programs. Investment spending such as outlays for civilian research and development are not reflected in these totals because this proposal addresses only the shortfalls in the physical and human capital areas.

2. Total reflects the sum of expenditures for adult labor-market training and youth training measures.

3. Beyond the $3 billion proposed by the Administration.

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