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Investing in Physical and Human Capital

Address by

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I am truly delighted to be here this morning. Back last spring when Dick Shinn invited me to be a speaker on this occasion, I promptly accepted. I knew, first of all, that being here would afford me the pleasure of seeing old friends. I also knew that I could count on an audience seriously concerned with the economic problems that confront our Nation. That, indeed, is the strong tradition of the entities from which this Council has been formed. As a former trustee of a life insurance company and as a former participant in the work of the National Bureau of Economic Research, I know something first-hand of your industry's record of sustained and generous support of scholarly research relating to economics and finance. Against such a background of considerations, your Chairman's offer to me was one I could hardly refuse.

I want to use my time at this rostrum today to share some thoughts with you about the troubles our economy is experiencing in reaching a satisfactory level of jobs and in purging itself of inflation. I make no pretense of being able to advance quick solutions for the problems we are living with. But I do have convictions about some steps that ought to be taken -- and others that ought to be shunned -- if we are eventually to extricate ourselves from our present condition.

In my judgment, inadequacy of investment in plant and equipment -- and also in human capital -- is the most important reason why the ongoing economic recovery has been somewhat disappointing; it also is a factor in explaining why so little headway is now being recorded in lowering the basic inflation rate.

In characterizing the present recovery as disappointing, I do not want to be misunderstood. In view of the disabilities our economy accumulated over a long span of years, it would have been extremely difficult -- no matter how skillful policy-making had been -- to achieve a recovery that was dramatically better than we have actually experienced. It is a statistical fact that this recovery has been of roughly average vigor compared with previous expansions since World War II. Indeed, it has been impressively better than average by the yardstick of increases in employment.

Still, there is ample reason for the sense of disappointment that so many people feel. Partly because of the unusual severity of the last recession, and partly also because of the accelerated expansion of our Nation's labor force, the recovery of our economy since early 1975, while of substantial scope, has left us with a disturbingly large total of unemployment. As you well know, the national unemployment rate is currently about 7 per cent,

and it has exhibited a stickiness at that level for the last half year. Large segments of our work force, moreover, have been unusually hard hit. Young people and nonwhites especially have faced formidable difficulties in the search for jobs. The unemployment rate for blacks -- approximating 14 per cent at present -- has shown no real improvement during this economic expansion, and the unemployment rate for black teenagers has soared to the dismaying level of nearly 40 per cent. Clearly, we are a long way from satisfactory conditions in our labor markets.

I need hardly add that recent price behavior also has been disappointing. During the recession period, inflation did slow considerably from its puffed-up double-digit pace. During the last two years, however, despite considerable slack in both product and labor markets, the basic rate of inflation appears to have settled at an annual rate of about 6 per cent. This reflects the fact that businesses have been granting annual compensation increments of between 8 and 9 per cent on average, while experiencing productivity gains that recently have not averaged much above 2 per cent.

The picture of economic performance before us is thus blemished by having in it both too much unemployment and too much inflation. I know of no one who would take exception to

that assessment. Where differences arise, of course, is with respect to remedial action.

Throughout most of the past thirty or forty years, the dominant view in this country -- as in much of the rest of the world -- has been that a condition of significant slack in the economy requires aggressive pursuit of fiscal and monetary ease; in other words, the government would have to run a sizable budget deficit by spending more or taxing less, and such a fiscal policy would need to be accommodated or reinforced by liberal supplies of money and credit. In this philosophic approach the kind of fiscal stimulus to be employed came to be viewed as much less important than its size. Giving the economy an adequate push and repeating the push again and again if necessary -- that was the crucial imperative of economic policy.

This simplified Keynesian mode of thinking consistently tended to overlook structural rigidities in our economy. It also proceeded on the mistaken assumption that upward pressures on the price level would come into play only when high rates of resource utilization were achieved. Despite these blemishes of thought, Keynesian-type remedies worked reasonably well as long as they were applied in moderation. But their very

success led to overdoing. With caution thrown to the winds in the mid-sixties, a relentless inflation has since then engulfed our economy. As a result, fears or expectations of inflation have become a vital fact that must now be reckoned with.

In this new economic environment, Keynesian-type remedies do not work as effectively as they once did. Many people have learned that larger governmental deficits and aggressive monetary ease are often forerunners of a new wave of inflation. Hence, when expectations of inflation mount, consumers are nowadays apt to save more rather than less, and such behavior obviously tends to offset the stimulating impulses that stem from a liberal fiscal policy. The like tends to be true of business behavior. Many, if not most, businessmen have learned that inflation inevitably confuses the calculation of costs, that in our present institutional setting it is generally destructive of profits, and that it sooner or later throws the economy out of balance and thereby leads to recession. Thus our economy is no longer working as it once did, and this paramount fact is now better understood than it was five years ago or even one year ago.

Nevertheless, mechanical Keynesianism still retains a strong grip on the thinking of many opinion makers in our country and abroad. Let the Federal Reserve, for example, move to restrain a burst of money growth -- as it has felt compelled to do during the past half year -- and such action triggers a torrent of protest. Much of the protest is predicated on the simple proposition that any rise of interest rates in the context of a less than fully employed economy jeopardizes continuance of economic expansion. The consideration that unimpeded money growth -- if allowed to proceed under recent conditions -- would greatly heighten expectations of inflation has been virtually ignored by the critics. Yet with such a heightening of inflationary expectations, long-term interest rates -- which have become extremely sensitive to inflationary psychology -- would surely have moved upward, in contrast to their actual behavior in remaining essentially stable. I need hardly add before this audience that long-term interest rates are far more important to the proper functioning of our economy -- especially for homebuilding and capital formation generally -- than are short-term rates.

The same attitudes that trigger protest whenever interest rates go up are also continuing to color thinking as to what constitutes appropriate fiscal policy. Let there be, for instance, a show of hesitancy in the expansion of the economy and proposals immediately come forth in great number urging stimulative governmental action. Only rarely is there any careful effort to tailor recommendations to identified specific weaknesses of economic performance. The overriding concern rather is with enlarging aggregate demand for goods and services by the quickest possible means. That, of course, was the genesis of last winter's 50-dollar rebate scheme; and for a while at least, mechanical Keynesianism again inspired a good deal of thinking this autumn about how to keep economic recovery going next year.

I submit that our country will not succeed in making much headway against the problems that our economy is burdened with until we shed such conventional thinking about stabilization policies. Fortunately, I believe we are moving in that direction. I do not underestimate, however, the distance that yet needs to be travelled.

The way in which we as a Nation deal with the problem of investment inadequacy will tell us whether policy making is

in fact evolving constructively. As you in the audience know well, spending by American business on capital goods has been weak in this recovery relative to that in previous expansions. This weakness is all the more glaring when one takes into consideration the fact that a significant portion of capital spending is now devoted to governmentally mandated pollution-control and safety equipment that in no way enlarges industrial capacity. Moreover, recent business investment in capital goods has been disproportionately concentrated in relatively short-lived assets such as trucks, office equipment, and light machinery. Businesses have shown marked reluctance to undertake major investment projects where payback cannot be expected for many years. This failure of investment to show greater vigor has cost our economy many hundreds of thousands of jobs.

For a considerable while, the conventional explanation for the weak showing of investment activity was the low rate of utilization of industrial capacity. The counsel was not to fret, that capital investment will be re-energized as aggregate demand grows. However, as we moved up the scale of capacity utilization, investment in major, long-lived investment projects has continued to be characterized by a good deal of caution. My own view --

which I have spelled out on previous occasions -- is that businessmen's hesitancy in initiating major investment projects is fundamentally grounded in a deep sense of uncertainty about how the economic environment is likely to evolve over the next few years. That uncertainty -- coupled with what has been a record of poor profitability in recent years -- is the real barrier, I believe, to more normal investment activity.

To the extent that is true, indiscriminate Federal injections of purchasing power into the economy would do little to end business reluctance to invest in major projects. To achieve a substantial lift in capital formation, specific attention to the shortcomings of the business environment is needed -- particularly, to uncertainty about governmental policy concerning taxes, inflation, energy, and environmental controls. The need to reduce business taxes has become especially acute: first, in order to offset impending increases in social security and energy taxes; and second, to neutralize the massive overpayment of income taxes that stems from applying standard accounting rules to our inflation-ridden economy. Fortunately, perception of all these needs has been growing.

I believe that President Carter fully appreciates the importance of substantially lessening the psychological and financial obstacles to business investment. The like is true of many influential members of the Congress. I therefore expect that economic policy generally -- and both tax and energy policy specifically -- soon will take on a more constructive character. Over the next several months, I anticipate that decisions in Washington will at last reduce uncertainty, improve the state of business confidence, and encourage capital formation. Even now, there are some indications that investment in heavy machinery and in industrial construction projects is beginning to revive, and this tendency is practically bound to be reinforced by the more constructive turn of economic policy that now appears to be emerging.

The need for a stronger trend of business investment is important both for short-range and longer-term reasons. So far, the driving force of economic recovery has been supplied overwhelmingly by consumer spending and homebuilding. The outlook remains favorable for continued expansion in these activities, but it would not be at all surprising if further gains moderated. The consumer saving rate has become rather low and cannot reasonably be expected to drift downward; and the rate of housing starts has attained a level suggesting that

additional gains in the coming year are likely to be modest. Thus, if the rate of over-all economic growth is to be strong enough to reestablish a declining pattern in unemployment, it is vital that investment activity take on new vigor.

And there are other compelling reasons for fostering an environment favorable to capital formation. Historically, the enrichment of our labor force with a greater quantity and improved quality of capital goods has been a major source of productivity gains in our country and, consequently, of advances in "real" income per worker. One of the worrisome features of the lag in capital spending of recent years is that it has come at a time when growth in the labor force was accelerating. The combination of these trends has resulted in drastically slowing the secular updrift in the amount of fixed capital available per worker. Whereas in the 1950's and 1960's the ratio of capital stock to the work force increased by more than 2 per cent a year, it rose by only about 1 per cent in the early part of this decade and has actually slipped somewhat in the last two years. It should not be surprising that the slowing in the growth of capital investment has been accompanied by a slowing of productivity gains; output per manhour has risen a third less

rapidly over the last ten years than in the 1950's and early 1960's. By revitalizing the process of capital formation, productivity gains are likely to improve again and thus help to reduce the cost pressures that keep driving prices upward.

The imbalance that has been developing between capital formation and labor force growth has one other troublesome implication that needs to be brought into sharp focus. At present, the issue of potential capacity shortages does not arouse much interest, since capacity margins generally are quite comfortable. But when one bears in mind the long lead times in bringing major capital projects to completion, the emergence of a serious mismatch between industrial capacity and labor supply within the next several years is not difficult to visualize; that is to say, the practical limits of capacity utilization could be reached before unemployment is reduced to an acceptable level. That may well occur if we do not generate enough growth in industrial capacity to match the growth of our burgeoning labor force. In short, the case for substantially enlarged business spending on plant and equipment has become very powerful. Since this is coming to be increasingly understood and since fairly clear avenues for a governmental contribution to a better investment climate beckon, I am optimistic that the general economic outlook will indeed brighten.

I wish I could be equally sanguine that we will deal appropriately with the barriers that stand in the way of job opportunities for so many of our citizens. To the extent, of course, that encouragement of capital formation helps to produce a more balanced and stronger expansion of the economy, employment will be stimulated. But even with additional momentum imparted to the expansion, it is doubtful that the unemployment rate will drop over the next few years to a reading that would be commonly regarded as acceptable. The reason for skepticism is that a formidable array of structural factors is now impeding the smooth functioning of our labor markets -- much more so than was the case ten or twenty years ago.

The most prominent of these is the recent upsurge in the growth of the labor force -- a phenomenon dominated by sharply increasing participation of adult women. I mentioned earlier the substantial increase in employment since the recession trough of March 1975. In fact, the growth of jobs since then -- totaling almost 7 million -- has been larger, in percentage as well as in absolute terms, than during the comparable phase of any of the economic expansions since World War II. However,

the increase in the labor force also has been exceptionally large in the course of this expansion -- amounting to more than 6 million persons. Consequently, the reduction in overall unemployment has been quite limited.

The greatly increased participation of women in the labor force that has developed in recent years marks a revolution in the role of women in our society. The pressure of inflation on household budgets has spurred many women to seek supplementary family income, but it is clear that fundamental changes in social attitudes toward family life and careers for women have also played a large role. In March 1975, women of age 25 or over participating in the labor force constituted 43 per cent of the adult female population. If this percentage had remained unchanged, the adult female labor force would now be lower by about 1.6 million. The large "extra" influx of female job seekers has, of course, taxed the absorptive capabilities of the labor market. So, too, have the large additions of young people seeking gainful employment -- a reflection of the high birth rates of the 1950's and also of the rising rate of participation by young people in the labor force.

Both young people and adult women newly entering the labor market tend to have unemployment rates higher than average, in large part because they often lack relevant work experience. Their increasing role in the labor force has thus imparted a significant upward tilt to the over-all unemployment rate compared, say, with the situation twenty years ago. That upward tilt has been reinforced by a number of other developments. The liberalization of both unemployment insurance and welfare programs has clearly increased the potential for extended idleness. The very fact that we have become a more affluent people also has made it possible for many individuals to be more selective in their search for work. Evidence has grown, too, that minimum-wage legislation has become an increasingly significant deterrent to the employment of young people. And the reporting of unemployment has been influenced to some degree by the fact that being unemployed is sometimes a requisite in establishing eligibility for welfare benefits.

The combined effect of these and lesser structural influences cannot be gauged precisely. There is, nevertheless, fairly common agreement among careful analysts that an unemployment rate of something like 5 or 5-1/2 per cent would

now be the economic equivalent of a 4 per cent rate, say, two decades ago. This does not mean that we need permanently reconcile ourselves to such a level of unemployment; but it should caution us, as we strive to bring the unemployment rate down, that we are likely to experience labor-market tautness and resulting inflationary stresses at a much higher level of joblessness than in the past.

In time, of course, some part of the upward bias now affecting the unemployment rate should automatically lessen. Growth in the younger-age component of the labor force can be expected to taper off in the next few years, reflecting the decline in birth rates that started in the 1960's. A lessened influx of young people into the job market should ease competition for youth-type jobs. And as the proportion of adult women with work experience increases, the incidence of unemployment among them should also gradually diminish. Such ameliorative tendencies, however, are likely to impinge slowly on the over-all unemployment rate, and particularly stubborn obstacles to lowering black joblessness could well persist. The rush of white adult females into the labor force appears to have been responsible for some crowding out of less educated black workers, both male and female. And

still another kind of competition may now be affecting younger black workers -- that stemming from the sizable decline in the college enrollment rate of white youths since the late 1960's.

In view of the complex forces that have recently come into play in our job markets, an over-all unemployment rate well above that which used to be regarded as normal remains a prospect for a considerable time ahead -- in the absence, that is, of effective countering strategies. A persistently high unemployment rate would, of course, entail great wastage of economic potential for the Nation, and -- what is of greater consequence -- it would destroy all hope of a decent place in life for hundreds of thousands of citizens. The need to address the structural influences that overhang our labor markets has become especially urgent for young people and black workers. The jobless rate of about 40 per cent for black teenagers and of more than 20 per cent for blacks between the ages of 20 and 24 express a tragic failure of our economic society. Unless we deal with that phase of unemployment constructively, whatever else may be done by way of trying to arrest and reverse urban deterioration is going to make little difference.

I have long argued, as some of you know, that a major impediment to job opportunities for unskilled workers is governmental interference with wage determination. However well-intentioned such action may be, our government has inflicted grievous injury to disadvantaged members of the labor force by mandating ever higher wage minima. An employer's decision to hire or not hire a particular individual depends critically on the relation between the wage of the employee and his likely productivity. When government raises the cost of hiring workers, as has just been done under a new minimum-wage statute, no compensating increase takes place in their productivity; hence it becomes more difficult for some workers to retain their jobs and for others, particularly young people and other low-skill workers, to find jobs.

Despite widespread infatuation with raising wage minima, the perversity of such legislation is gradually being recognized. It is noteworthy that a proposal for a special sub-minimum youth wage lost by only one vote this year in the House of Representatives. That is the closest we have come to a sensible departure from our mistaken course. If this whole issue is not reopened in the next session of Congress, it would be desirable, at the very

least, to seek legislation for a pilot experiment with a youth differential in, say, a half dozen cities with a view to demonstrating actual consequences of a lower minimum wage for young people. At the same time, and for much the same reasons, I would urge attention to the harmful results, especially for young people and blacks, of the wage floors mandated by the Davis-Bacon Act and the Walsh-Healy Act, which deal respectively with Federally financed or assisted construction projects and with work performed on manufacturing and supply contracts of the Federal Government.

We need to understand that widespread access to jobs -- especially for young people -- is the surest way a society has of facilitating sound investment in human capital. Normally, the time for learning skills is when one is young. To the extent that meaningful work experience is blocked for young people, they can hardly be expected to become useful, productive citizens. Our legacy of missed training and of failure to acquire basic work habits will plague this country for literally decades ahead. The past cannot be undone, but that is all the more reason to prevent further human wastage by opening more channels to jobs that afford useful learning opportunities.

Public-service jobs that fail to teach transferable skills, as is often the case, merely disguise the problem. So, too, do income-maintenance welfare programs. Again, I wish to avoid misunderstanding. I happen to favor public-service jobs that provide useful training, and I certainly do not oppose thoughtfully structured income-maintenance efforts for the needy. I do believe, however, that we must guard against social attitudes in which either course is seen -- in the case of young people especially -- as a tolerably acceptable alternative to entry into the mainstream of the job market.

Governmentally mandated wage minima are by no means the only institutional obstacle to the assimilation of young people and minorities into the active work force. Sooner or later -- if only as an anti-inflationary step -- we will have to come to grips with other artificial restrictions to employment opportunities that have developed in our country. In particular, attention needs to be directed to governmental licensing and certification requirements that limit entry to various occupations. It is hard to see, for instance, economic or social justification for the extremely high cost of becoming an owner-operator of a taxicab in this and other cities. Nor is it easy to justify the licensing requirements that complicate entry to trades that range from barbering to plumbing. Such licensing is at times merely a form

of disguised monopoly that makes it difficult for people, especially members of minorities, to enter fields that otherwise would accommodate many additional workers.

The opening up of job opportunities for young people and minorities clearly needs to be reinforced by improved education in primary and secondary schools. Despite the rapid closing in recent years of the wide educational gap that used to exist between whites and blacks, educators generally agree that the quality of black education is still markedly inferior. Diplomas and credentials alone mean little. What is critical on graduation is what has been learned that is useful for job performance. Too often, the knowledge acquired does not enable the graduate to be of much value in labor markets. Too often, habits important to employers -- such as punctuality, a sense of responsibility, and personal neatness -- have not yet been acquired. All this is an extremely important aspect of our failure as a Nation to invest wisely in human capital.

I lack the practical knowledge to comment at any length on the enormous challenge of improving inner-city schools. But I do know that here and there schools of excellence exist within inner cities, thereby demonstrating -- among other things --

that great financial cost is not a requisite condition for good schooling. It is promising that a good deal of scholarly examination of these schools is now under way, so that in time their procedures can be emulated elsewhere.

The approach I have suggested for dealing with youth and minority unemployment involves proceeding on a number of different fronts. I am convinced that there simply is no grandiose scheme by which our economy's complex problems of structural unemployment are going to be solved. I realize it is tempting to think that very rapid expansion of demand through monetary and fiscal stimuli would pull many of those who are now sidelined in idleness into the mainstream of the Nation's economic life. And, for a while, it is possible that an effect of that kind would occur in some measure. But experience of recent years should by now have driven home the truth that such policies cause inflationary pressures that are inimical to sustained prosperity. Temporary benefits conferred on young people and minorities would only leave a legacy of bitterness once the distortions of inflationary stress caused the bubble of prosperity to burst, as I have no doubt would again be the case.

I well realize that, despite my neglect of numerous problems, including the plight of many older citizens, I have ranged this morning over a wide terrain. I hope that in so doing I have not blurred my central thesis. That is simply that our Nation urgently needs to enlarge its investment in both physical and human capital: first, to solidify the ongoing recovery of production and employment; second, to put our economy on a track that will carry us to sustainable conditions of improved economic health in which all of our citizens will have a decent chance to share.

Among other benefits, accelerated investment in physical and human capital will materially aid our economy in making headway against the scourge of inflation. The prospect of reducing the pressure of costs on selling prices will brighten as improvements in productivity strengthen. A vital key to that achievement is more and more modern capital equipment per worker together with a better trained work force. And the act of unblocking job avenues for workers, while politically difficult, will in time not only serve to reduce unemployment; it will do so without releasing inflationary waves that are bound to follow from excessive fiscal or monetary ease.

In closing, I would like to make just one further point. You in this audience have tremendous capability -- through this Council, your companies, and as individuals -- to make a difference in the battle for a healthier economy. I well remember the impressive effort your industry made years ago to counter the insidious theory that a little inflation is a healthy thing. I know you are continuing your educational endeavors. But I would urge you to stretch your energies and to share even more fully with your policyholders -- a multitude almost coterminous with the public at large -- the special insights that you have accumulated into the economic and social damage caused by inflation and unemployment. Widespread understanding of economic problems has become crucial to the vitality of our democracy. Your industry has a proud record in improving economic knowledge, and I am confident you will continue to build on it.

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