Economic Policy

AN AGENDA FOR THE NINETIES

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CONTENTS

TABLES

1
ECONOMIC PRIORITIES

THE DEFICIT AND THE DEBT BURDEN

Peter Peterson[1] and Felix Rohatyn[2] have been leading the chorus that the deficit is the number one economic problem. All the disasters go back to this source: the stock market crash, the rise (and fall) of the dollar, the huge trade deficit, and the decline of manufacturing. The deficit reached 6.3 percent of the GNP in 1983 and still was as high as 5.2 percent in 1986. Congress became panicky enough to limit its discretion in spending by passing the Gramm-Rudman-Hollings amendment. Even now that the deficit is down to 3.1 percent of the GNP, we still hear that it is the great problem.

Yet one should be skeptical about so simple a message. The deficit alone is unlikely to be at the root of such an assortment of economic events. This book shows that the rise of the dollar was not primarily due to the deficit. At the outset of the eighties, the Fed, confronted by a high rate of inflation, conducted a harsh, tight monetary policy. Paul Volcker, the chairman at the time, was prepared for the consequence of a rise in unemployment. The theory underlying the policy predicted that inflation could be brought down only at the cost of some unemployment. The theory did not predict that the dollar would rise, and Volcker did not expect this consequence. The other major development that was not anticipated was the growth in the demand for credit by business and consumers. This growth far exceeded the growth in the demand for credit resulting from the federal deficits. The economists who worry about the deficit ignore the Fed's monetary policy and the growth of private debt. Moreover, the rise in the dollar did not have a devastating effect on manufacturing. A careful look reveals that manufacturing has performed well. Some workers have lost their jobs, but this was due more to productivity growth than to the trade deficit. In general, economists have been too quick to see economic collapse and to blame the deficit for the loss of employment in manufacturing. Some economists have worried about the huge debt burden we are imposing on future generations. Reagan tripled the federal debt, and the interest on the debt now takes as much as 14 percent of total federal expenditures. Our children and grandchildren will bear a heavier weight.

But the burden may not weigh as heavily as we fear. If the Treasury is borrowing to finance buildings, roads, hospitals, and other investments, then why worry? In that case the gap between revenues and expenditures is no deficit. It is an investment financed by borrowing. No one accuses GM of running a deficit when it borrows to finance a new plant.

However, the federal deficit may exceed the investment spending. Whether or not it does, the answer depends on how we evaluate individual expenditures. Should we list the purchase of an aircraft carrier as an investment? Its life expectancy, unless a war comes, may be 20 years. It should be written off over that period, not over the period of construction. If we treat all weapons procurement in the same manner, then nearly half the deficit would vanish. The counterarguments are that today's new weapons are obsolete tomorrow and that a war will destroy them. Caution dictates the treatment of all defense expenditures as current expenses.

A more convincing case for long-term depreciation can be made for government buildings, roads, canals, bridges, and so on. Businesses would not write off such investments immediately. However, the case is not compelling. Government investments may be unproductive, while a private developer will not undertake a new building before it is certain of its marketability. Mistakes are made, but the developer bears the losses, not the general public. A partial allowance should be made for government investments, but it may not be enough to offset the deficit. Despite government investments, we may be piling up an excessive burden for future generations by running large deficits each year.

THE DEFICIT, THE INTEREST RATE, AND THE DOLLAR

In any case, our children's welfare is not our immediate concern. We read all the time that the deficit is wrecking the economy. If we believe Peterson and Rohatyn, it has ruined U.S. manufacturing. The links in the chain of argument are as follows. The deficit forces the Treasury to borrow heavily. This huge demand for loans raises the interest rate on bonds generally. Attracted by the high interest rate, Japanese, German, and British investors buy U.S. securities. To do so, they must buy dollars and sell yen, deutsche marks, and pounds, pushing up the exchange rates for the dollar. By selling yen to buy dollars, they raise the price of the dollar in yen—the exchange rate for the dollar in yen. A high dollar means high prices for U.S. goods in yen and other currencies. Expensive American machine tools do not sell well, and our exports fall. When the dollar is high the prices of Japanese and other nations' televisions, radios, machinery, and so on are low in dollars. One dollar can buy a lot more yen. Goods that you need yen to buy become cheap. Imports become cheap, and U.S. manufacturers lose sales at home. So Reagan's deficit has cost American workers their jobs.

There are some problems with this analysis. The dollar went up before Reagan's big deficits, so they cannot be the cause. Peterson and Rohatyn ignore the Fed's part in pushing up the dollar. They have forgotten that to slow down the consumer price index in 1980 and 1981, which was galloping at the annual rate of 13 percent, the Fed raised the interest rate to a high level. The Fed tightened money, the interest rate went up, and with it the dollar. Then came the recession of 1981 and 1982. The first big deficit came only in 1982.

Nor are the Fed and the deficit together the whole story. The eighties have seen the great American borrowing binge. Urged on by banks' advertising, consumers have had a love affair with their credit cards, and businesses also have been borrowing heavily. Lots of people and businesses have been running big deficits, not just the federal government. The interest rate rose because the private demand for credit went to new high levels.

What is more, the dollar has come down. In 1985 and 1986 the dollar fell while the deficit remained high. This apparently does not bother the deficit bewailers; now they blame the deficit for the drop in the dollar.

The deficit has caused no great economic disaster. True, the great rise in the interest rate in 1980 and 1981 cost many workers their jobs. People who might have built homes could not afford to make the interest payments. Business investment fell. The dollar rose and U.S. manufacturing lost sales both abroad and at home. But the deficit was not the source. This does not mean that the new administration can cavalierly dismiss the deficit as of no consequence, but it is not the great source of all our current economic problems. The Fed was behind much of the rise in the interest rate. The new Bush administration should understand that the Fed has exerted a great deal of economic power; it is a very activist, powerful organization. It brought on the recession of 1981–82 with its tight monetary policy. Before congratulating the Fed for its courage in fighting inflation, we should recall that it was attempting to correct the effects of its errors in 1976 and 1977 when its easy monetary policy exacerbated the already high rate of increase in prices. Fed Board Chairman Paul Volcker, who took office late in 1979, became a hero because he conquered inflation. But the heroism was made necessary because his predecessors fed the inflation.

In addition, it is not clear that Volcker's forecasts were better than those of his predecessors. It is unlikely that he foresaw the severe consequences of his actions. If he had known that the recession was to be be as bad as it was, he might have eased up. Nor is it likely that he expected the policy to drive up the dollar as much as it did. Since it is so poor at forecasting, the Fed should refrain from exercising as much power as it has in the past. If the Fed cannot correctly anticipate the consequences of its actions, then if it acts at all it should do so with great restraint. The administration cannot control what the Fed does, but it does have some influence. The Bush administration should urge the Fed to lean toward greater moderation.

THE DEFICIT AND THE STOCK MARKET CRASH

A major goal of the Bush administration will be to prevent a recession. We have enjoyed a long prosperity. It is seven years since the bottom of the last recession, and this is a long time as cycles go. The stock market crash of October 1987 threatened to bring one on, and the administration should try to avoid another one. If the stock market goes through another 500-point fall, it may bring the economy down with it. We have to understand the source of the 1987 collapse to develop a policy. Again we hear about the deficit. Peterson predicted the crash in the October 1987 issue of *Atlantic Monthly*. This success gave great weight to his diagnosis. However, the deficit was not the cause. The market had barreled along despite big deficits for five years. What is more, the deficit in 1987 was much smaller than it had been.

The crash was due to the Fed's action. Here we see another instance of the Fed exercising its great power and of its inability to forecast the results of its actions. The Fed raised the interest rate between February and September 1987. Inflation fears and pressure from foreign central bankers, who did not want to go on supporting the dollar in foreign exchange markets, led the Fed to push up the interest rate. The stock market was at a high level—the boom had been going on for a long time—and stock market prices generally are sensitive to movements in the interest rate. Hence the collapse.

The Fed acted to tighten the supply of money without full awareness of the effects of its policy. The immediate goal of preventing a further decline in the dollar blinded it to other consequences. The Fed did not anticipate the effect of its policy on the stock market. The Fed's vigorous intervention in the money market raised long-term as well as short-term interest rates substantially. After the fact it was no surprise that the Fed's actions produced the stock market disaster. Many people lost their savings, and many others lost their jobs. The important point to bear in mind is that the Fed did not expect to set off the stock market crash.

The Fed's economists neither are smarter than those elsewhere, nor do they have a clearer crystal ball. Economists predict interest rates, foreign exchange rates, GNP, employment, and so on on the basis of past observations. Unfortunately, past relationships did not continue. The past is not a reliable guide to the future, especially after people go through extremes of either inflation or recession.

The prospect of another stock market crash should not drive the Bush administration to drastically cut the deficit at whatever cost. The administration may not be able to do much, since it is the Fed that runs this country's monetary policy. Again, the administration should press the Fed to act in a moderate manner. The Fed thought prudence demanded vigorous action to prevent inflation, but it could not foresee the market collapse and a high risk of recession.

THE DECLINE OF MANUFACTURING

Peterson and Rohatyn join many economists in deploring the decline of U.S. manufacturing. We read that employment in manufacturing has dropped, and that many unskilled former assembly workers cannot find jobs. Those that do must work at low-paid jobs as baggers and stock clerks in supermarkets, as dishwashers and busboys in restaurants, and as orderlies and cleaners in hospitals. America can no longer compete. Peterson and Rohatyn point to the deficit and the high dollar.

Others, including economists Lester Thurow[3] and Robert Reich,[4] point to the low productivity growth of U.S. factories and the poor quality of the goods they produce. They do not see the deficit as the primary source of the decline; they agree that there has been a decline. For Thurow and Reich, Japan is the model. Its government has directed economic growth by subsidizing certain favored industries and by protecting them against import competition. The secret of Japan's success is the government's industrial policy. Thurow and Reich urge the United States to imitate the winner.

The AFL-CIO and the Cuomo Commission on Trade and Competitiveness also urge an industrial policy. The AFL-CIO specifies a long list of industries that should be protected against imports. The Cuomo Commission urges market-sharing agreements with other countries for industries afflicted by destructive competition arising from world overcapacity.[5] The commission believes that the fundamental problem is the world overcapacity in many industries. Both the AFL-CIO and the Cuomo Commission urge the government to set up a development bank to finance investment in unspecified industries, especially in depressed areas. The industrial policy for each industry will be run by a labor-management-government committee.

An industrial policy means government sponsored cartel agreements for some industries, protection against imports, and subsidies to firms in some industries. Taxpayers and consumers will pay the bills to maintain employment in some declining industries. Prices will be fixed at high levels, and where necessary the government will foot the bills.

The Bush administration should not undertake so radical a policy unless the economy—and more particularly manufacturing—is performing badly. However, we cannot say that manufacturing is performing badly simply because its employment has dropped without knowing the cause of the drop. According to industrial policy proponents, U.S. manufacturers have lost markets to Japanese and other competitors. Productivity growth has been poor, efficiency is low, costs are high and quality is poor. The condemnation of U.S. manufacturing performance is based on comparisons between Japan and the United States in a selected sample of industries, as well as on the drop in employment.

However, a full review of the evidence shows that the loss of jobs in manufacturing has been due largely to the growth of productivity, not loss of markets. Manufacturing has performed so well that it has produced more goods with fewer workers. Employment in this sector has fallen both absolutely and as a share of the total labor force. Machine operatives have lost their jobs and have had to depend on unemployment benefits as long as those last. Then they have had to become hamburger flippers. It is only when measured by employment numbers that manufacturing has declined. When measured by output, manufacturing has grown and has increased in importance. Manufacturing output has grown faster than the output of the service industries.

Even by international standards, the United States has not done badly. Manufacturing productivity growth has lagged behind that of Japan, but it has done well compared to other developed countries. Moreover, the lag behind Japan has many causes. It is doubtful that imitating Japan's industrial policy will remove the lag. We also hear that the United States has lost world market share in many products. This is inevitable when such less industrialized countries as South Korea and Taiwan are growing more rapidly than any developed country. Compared to other developed countries as a whole, our manufacturing industries have not lost market share. Japan is the only one whose world market share is growing more rapidly. Again, this has many causes. Perhaps now that the dollar is down from its earlier high level, U.S. manufacturers' market share will grow more rapidly than that of Japan's manufacturers.

American manufacturing has performed very well in the eighties. Manufacturers have become more efficient and productivity has grown rapidly. There is no need for an industrial policy. It is unfortunate that employment has declined and former workers have lost their jobs or have had to take low-paid jobs. However, to have made the productivity improvements while maintaining the same level of employment would have required an unrealistically great expansion of output. No industrial policy could have achieved such expansion.

THE BUDGET

The past Congress exaggerated the deficit problem. But a correct assessment of the problem should not prevent the Bush administration from raising taxes and reducing expenditures. Unless a recession intervenes, reducing the deficit does not present an insuperable problem. Moreover, there will be demands for additional expenditures. The quality of services provided by state and local governments has deteriorated to unacceptable levels, and these governments are in a poor position to raise the necessary funds. There will be other demands for new expenditures.

The deficit rose because Reagan, together with Congress, reduced tax rates while raising defense expenditures. Reagan said no deficit would arise because with lower tax rates businesses would reap more of the benefits of their investment and workers would retain more of their earnings. Everyone would work harder, incomes would go up, the lower tax rates would generate more taxes, and the budget would be in balance. This was the supply-side theory. The theory overestimated the incentive effect of the tax reduction, and the budget went into deficit.

The personal income tax can be raised easily by the three or four percentage points needed to eliminate the deficit. If there is too much resistance to raising personal income tax rates, then the administration might propose imposing a value-added tax, which many countries in Europe already have. The value-added tax is similar to a sales tax, but it is imposed at each stage of production and distribution on the value added to the goods or services at that stage. It is a great revenue producer. A tax rate of 2 or 3 percent would take care of the deficit. No great economic problems would result from raising the funds either from higher personal income tax rates or from a value-added tax.

On the expenditure side, the big items are defense, social security, medicare, interest, and others. Interest and social security are sacrosanct. The cost of medicare is more likely to rise than to fall with the growing demand for medical care by the elderly. Congress has recently agreed to meet the costs of catastrophic illnesses for the elderly. The "other" category has already seen sharp cuts, particularly expenditures for poverty assistance. This category is unlikely to offer significant opportunities for reducing the deficit.

Defense offers the greatest opportunity. However, without fundamental policy changes, we are unlikely to see great reductions in these expenditures. The major categories of expenditures are personnel, operations and maintenance (O&M), and procurement. The administration cannot cut either personnel or O&M substantially as long as it maintains its present commitments to Western Europe. The withdrawal of U.S. forces would permit very great reductions in expenditures, but only if the forces are reduced overall, not merely restationed in the United States.

Such a drastic change would require a reassessment of the Soviet threat and of the ability of the Western Europeans to maintain adequate defenses. We may be ready for such a reassessment. Since World War II the United States and its allies have exaggerated the Soviet threat. In recent years the estimates of Soviet defense expenditures have come down substantially. We also now know that apparently aggressive actions by the Soviet Union in the Berlin and Cuban crises were not motivated by expansionist goals. Moreover, Western Europe now is rich enough to provide an adequate defense on its own. The forces need not be so large as to guarantee victory over invading Soviet armies. The Soviets will be deterred by the prospect of a costly war.

Procurement can be cut substantially without signficantly re-