ECONOMIC CHOICES 1984

Alice M. Rivlin
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Foreword

BY ADOPTING economic policies that resulted in large federal deficits and high interest rates, the United States has made a poor choice. Sharp reductions in these deficits would improve the chances for economic growth and restore the ability of U.S. industries to compete in world markets. But deficits cannot be brought down without cutting spending and raising taxes. The choices are painful.

The authors of this volume present a plan that would not only reduce deficits but also increase future flexibility in domestic spending, improve the effectiveness of defense expenditures, and reform the federal tax system. They also offer suggestions for coping with structural change in American industry and reversing recent increases in poverty. They offer their plan as a contribution to the national debate on economic choices that is sure to occur during the 1984 election campaign and in the next Congress.

The contributors to this volume are all members of the staff of the Economic Studies program at Brookings except for William W. Kaufmann, who is a consultant to the Foreign Policy Studies program and a member of the faculty of the Massachusetts Institute of Technology.

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BRUCE K. MACLAURY
President

May 1984
Washington, D.C.

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1

Overview

HIGH DEFICITS in the federal budget, together with high interest rates, are endangering the future growth of the U.S. economy and undermining the ability of American industry to compete in world markets. Change is needed. The federal deficit should be drastically reduced—indeed eliminated by the end of the decade—and interest rates should be lowered. Reducing the deficit will increase the resources available for investment and improve the chances for healthy economic growth. It will also allow interest rates to come down, reduce the value of the dollar in foreign exchange markets, and make American products more competitive.

Cutting the federal deficit will be painful. Spending growth must be reduced and taxes raised. But the need to reduce the deficit also creates an opportunity to reassess the priorities of the federal government. We believe that the domestic spending programs of the federal government can be made more effective, defense objectives can be attained at substantially lower cost, and a thorough overhaul of the federal tax system can make it both fairer and more favorable to economic growth than the present system.

The United States also needs new policies to facilitate economic change. In a growing economy, people and resources must move from less productive to more productive pursuits. Public policy should make these changes less painful, not retard them. It should foster innovation and help dislocated workers find new jobs. It should help the poor and the less skilled move into the mainstream of American society.

This volume focuses on some of the economic choices facing

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the nation in 1984 and lays out a package of proposals designed to enhance growth and facilitate change. It discusses why deficits should be cut and interest rates lowered. It proposes a plan for reducing the growth of domestic and defense spending and suggests a new system of federal taxation. It deals with changes in trade and labor market policy that could help adjustment to economic change and offers ways of assisting low-income people.

Why Growth Matters

Sustained economic growth should be a high priority of public policy. We should aim for an economy in which average incomes rise gradually over the years so that more is available for the satisfaction of both public and private needs. In the short run, as the economy recovers from the recession, rising incomes can be achieved by reducing unemployment and increasing the utilization of factories and other resources that were not used to capacity in the recession. Over the longer run, rising incomes require increases in productivity—output per worker has to rise.

In a growing economy public choices are less agonizing and divisive. It is possible to modernize the armed forces; keep the nation's infrastructure in repair; provide for the elderly, the sick, and the needy; improve education and other public services; and still have private incomes that rise after taxes. Public choices are never easy, but they generate far more conflict in a declining or stagnating economy, when an increase in the resources to meet one kind of need requires an absolute reduction of resources used to meet other needs.

Modern economies must undergo a continuous process of adaptation to new technologies and changing preferences of consumers. That change can involve serious hardship for workers and communities that have become dependent upon older, declining industries. But if overall employment is high and the economy is growing, it is much easier for workers in declining industries to find new jobs and for new firms to spring up to replace those that are in decline. It is less difficult

for young people to acquire experience and get established in careers.

Moreover, the experience of the postwar period indicates that overall economic growth is a powerful means of reducing poverty. Programs to provide education and job skills for low-income people have little chance of success if there are few jobs available and little prospect of a better income. Even if some proportion of those in poverty cannot be expected to participate in income growth, the provision of resources for their support is easier with a growing economy.

No economy can grow every year or at a steady rate. Moreover, rapid growth increases the risk of inflation. The goal of policy should be to get the economy on a moderate growth path, aiming for real growth in the neighborhood of 4 percent a year on the average, and moderating the fluctuations around the trend.

Factors Favorable to Growth

The rate of growth in real output is currently strong as the economy emerges from the deep recession of the early 1980s. Yet there are grave doubts that the expansion can be sustained in future years and fears that the economy could return to the weak growth and poor productivity performance that characterized the 1970s.

Actually, however, there were several factors that contributed to poor economic performance in the 1970s that seem unlikely to recur in the near future. One such strain on the economy was the rapid increase in the labor force, which grew by about 45 percent between 1965 and 1980. Most of the newcomers were inexperienced young people—the baby boom generation growing up—and others were married women with relatively little job experience entering the work force in increasing numbers. The economy absorbed this influx, but at some cost to productivity growth.

Two rounds of energy price increases in the 1970s raised costs and necessitated considerable industrial retooling to save energy. The energy price rises precipitated rapid inflation as business passed on costs to consumers and workers sought

higher wages to compensate for rising prices. Inflationary expectations caused consumers and businesses to act in ways that further aggravated inflationary pressures, and inflation proved extremely hard to control.

At the same time the economy was absorbing an explosion of regulation designed to protect the health and safety of workers and consumers, reduce environmental pollution, conserve energy, and promote equality of opportunity. This regulation helped make America a better place to live, but at the cost of some slowing of industrial growth and some aggravation of inflation.

These four factors—a labor force increase, energy price shocks, increased regulation, and stubborn inflation—are by no means the whole explanation for the slow increases in output and decline in productivity growth that affected not only the United States but most of the major industrial countries of the world in the 1970s. But they contributed to these developments, and fortunately they seem unlikely to recur in the near future. For the next few years, the United States will have an increasingly experienced labor force with relatively small numbers of untrained new entrants. Energy prices seem unlikely to rise rapidly unless there is a major conflict in the Middle East. Moreover, the United States now uses energy more efficiently than it did a decade ago and is far less dependent on imported oil. No major increases in regulation are in sight; indeed, regulation is being reduced in some areas. Inflation has been brought down from the double-digit levels of the late 1970s to rates of 4 to 5 percent a year. The reduction in inflation was purchased at great cost in unemployment and lost income in the 1980–82 recession, but it did occur. Barring outside shocks or excessive demand pressures, inflation seems likely to remain in the moderate range for at least the next few years.

If these four factors told the whole story, the outlook for growth in the next few years would be more favorable than it was in the 1970s. Unfortunately, the favorable outlook is threatened by an unfavorable policy: high federal deficits that reduce national saving, put upward pressure on interest rates, and prevent the accumulation of private capital necessary to sustain the expansion of output in future years.

The Outlook: High Deficits and High Interest Rates

For the last several years, monetary and fiscal policies—the two principal instruments by which the federal government affects the overall state of the economy—have worked at cross-purposes. Monetary policy has been predominantly restrictive; fiscal policy, predominantly stimulative. The result has been high interest rates and high deficits that will continue in the foreseeable future if policies are not changed.

Beginning in 1979, the monetary authorities, deeply concerned about the high inflation of the late 1970s, assiduously restricted the growth in the money supply. Interest rates rose to extremely high levels, and the economy went into a deep and lengthy recession from which it did not begin to recover until the end of 1982. Not surprisingly, the interest-rate-sensitive sectors of the economy were especially hard hit. Unemployment rose to over 10 percent of the labor force, while inflation dropped dramatically.

Meanwhile, fiscal policy was dominated by major reductions in personal and corporate income taxes that were enacted in 1981 and took effect during 1981–83. The revenue cuts were not matched by spending cuts, although the mix of spending shifted away from domestic programs and toward spending for defense and interest on the rising debt. As a result of both the recession and the cut in taxes without a corresponding cut in spending, the federal deficit soared to $193 billion, or 6 percent of GNP, in fiscal year 1983.

Since the end of 1982 the economy has been experiencing a healthy recovery that has affected all major sectors except net exports. Forecasters anticipate a 5 percent real increase in GNP in 1984 with declining unemployment and inflation remaining at a moderate rate of 4 to 5 percent.

Even if the economy continues to grow, however, the deficit in the federal budget will not decline unless current policies are changed. Although revenues will rise as the economy expands, spending will rise even faster, and the deficit will continue to increase. Even if the economy grew steadily through 1989 (as assumed in the projections of the Congressional Budget Office), unemployment fell to 6.5 percent, and interest rates

declined, the deficit would still climb from about $200 billion in fiscal year 1985 (5.0 percent of GNP) to about $300 billion in 1989 (5.7 percent of GNP). This prospect of a rising deficit in an improving economy makes the situation very different from any experienced in the past. Since World War II high deficits have been associated with recession.

These projected deficits are not attributable to the social security and medicare trust funds, which, taken together, are expected to be roughly in balance through 1989, thanks to recent increases in payroll taxes. The problem is in the rest of the budget. Spending for programs other than medicare and social security will total about 17.2 percent of GNP in 1985 and will rise slightly faster than GNP, with defense and interest dominating the increase. However, the corresponding revenues, which were sharply reduced by the income tax cuts passed in 1981, will be only about 12.7 percent of GNP in 1985 and will rise slightly slower than GNP. Hence the large and widening gap.

Government borrowing to finance the deficit is contributing to the high level of interest rates and can be expected to exert more upward pressure in the future as private credit demands increase. As workers and factories become more fully employed, the monetary authorities will have to keep a tight rein on credit to avoid a reescalation of inflation. The conflict between a stimulative budget policy and a restrictive monetary policy will intensify, and interest rates are likely to rise further.

Why Policy Must Be Changed

Budget deficits in the anticipated range will absorb about two-thirds of the net private savings expected to be available, leaving less for capital formation. To put the matter slightly differently, federal government dissaving will offset a large part of the saving of other sectors of the economy. While it is possible that saving by other sectors could rise to offset the dissaving of the federal government, private saving has been a remarkably constant fraction of GNP over several decades. It is more likely that federal dissaving of such unprecedented magnitudes will diminish the domestic resources available for

investment in plant, equipment, and housing and will drive up interest rates.

High deficits and high interest rates do not necessarily mean immediate disaster for the economy. The deficits will continue to stimulate the economy generally, while the high interest rates will tend to slow particular types of spending, especially housing and business investment. The result will be a shift in the mix of total spending—more resources for consumption, less for investment and housing. A low level of investment in plant and equipment is likely to reduce productivity increases and hamper economic growth in the longer run. Penalizing investment is borrowing from the future to increase consumption now.

Moreover, high interest rates have already had devastating effects on the ability of U.S. industry to compete in world markets. High rates have attracted a large inflow of capital from abroad. This foreign capital has helped finance the federal deficit as well as private investment, but has added to the demand for dollars on foreign exchange markets. The exchange value of the dollar has risen sharply in the last several years, which has made U.S. exports expensive for foreigners and foreign goods and services cheap for Americans. As a result, the United States has been running a huge deficit in its balance of trade; output and employment in industries facing foreign competition have suffered. Borrowing from abroad is also borrowing from the future for current consumption, since these debts to foreigners will have to be repaid with interest out of future national production.

High interest rates in the United States lead to high interest rates around the world and greatly aggravate the precarious international debt situation. As interest rates rise, third world countries find it increasingly difficult to meet the interest payments on their debts to U.S. banks.

In sum, we believe that the current mix of fiscal and monetary policy is a mistake. High deficits and high interest rates retard economic growth, damage U.S. competitiveness in world markets, and add to the strain on international credit. The United States should take action to lower the federal deficit and to bring interest rates down.

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