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An Ambitious Agenda for Economic Growth

by Murray Weidenbaum

In this presidential election year, it has become fashionable to advocate faster economic growth as the elixir to cure all that ails the American society. Surely an average annual growth rate in the neighborhood of 2 percent is anemic, whether we view it in historical terms or by the current standards of the economies of China and Southeast Asia. Faster growth produces all sorts of good things, such as lower budget deficits, more new jobs, higher incomes, and rising living standards. Thus, who can object to the general idea of achieving larger economic output?

Economists, of course, are destined to bring the wet blanket to the party. We have to raise the question ignored in this campaign: How can we achieve, and more importantly, maintain a more rapid and more durable pace of economic expansion? The two most popular ways of attaining faster growth fall short of providing a satisfying response. The first simple growth policy is to order the Federal Reserve System to put its collective foot down harder on the monetary gas pedal — or, at the least, to take the other foot off the monetary brake.

The second approach requires Congress just to cut taxes, providing a one-shot fiscal stimulus for a sluggish economy. Both responses are clear, simple — and in today's circumstances — inadequate or inappropriate. Both are kissing cousins, quick fix variants of the age-old desire to pump up the economy or — to continue the automotive metaphor — to put air in a flat tire without patching up the holes that are the basic cause of the problem.

In recent decades, we have learned that a rapid and sustained expansion of the money supply unaccompanied by substantial change in policy toward the real economy will mainly generate escalating inflation. Rising inflation, later if not sooner, will cause the Fed to shift gears

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and to pursue a policy of slowing the growth of, or even cutting, the money supply. In the process, interest rates will rise. More often than not, that sequence of actions will end the economic expansion and precipitate the next recession. So much for a faster growth track via monetary policy.

The currently popular fiscal alternative, just cutting tax rates, is likely to result in a similarly undesirable sequence of events. However, the process will probably be a bit more indirect. As an old budget hand — I cut my eyeteeth in Harry Truman's Budget Bureau — I always worry that proposed tax cuts will not be offset by new expenditure cuts. Merely meeting the requirements of balancing the budget under the existing tax structure is likely to exhaust all reasonable opportunities for reducing federal outlays.

Surely cutting income taxes alone is not going to energize the economy sufficiently to prevent a rise in the budget deficit. On the basis of experience — I also bear the scars of the 1981-82 cycle — those deficits can lead to a variety of negative effects. These range from a diminution of investment capital available for private business expansion to scaring the Fed into tightening the flow of money and credit.

A Nonpolitician's Approach

But mine is not a counsel of despair. There is a third way of responding to the poor performance of the U.S. economy. It, too, is a supply-side approach but it is more subtle — and avowedly more difficult — than just cutting taxes. We must deal with the structural defects in the American economy that depress productive capacity and productivity. Many of these defects arise from the operation of government policies and programs. The fact that, in the main, these adverse effects on the economy are unintentional provides an especial opportunity for reform. An example of these structural and institutional shortcomings will provide an inkling of the type of economic cure that I have in mind. Although the initial example is regulatory, my analysis will cover the gamut of government operations, especially expenditure programs and the tax system.

Dale Jorgensen of Harvard has estimated that, by the year 2005, when the new Clean

Air Act is fully in effect, the compliance with that statute and other environmental laws will reduce the nation's capital stock by over 4 percent. It will increase the cost of capital by more than 5 percent, and reduce the economy's growth rate by more than 3 percent a year.

Nevertheless, there is no responsible pressure to dismantle these environmental programs. The Manufacturing Institute, for example, suggests that reasonable regulatory and tax reforms can yield technological advances and greater capital investment which could raise the growth rate by half a percentage point. If that number seems small, please remember that compounding it over a decade generates a large cumulative increase in production, income, employment, and living standards.

To clear the air (I mean that in more than one sense), this is not a plea to swing the public policy pendulum from the present polar alternative of increasingly tough environmental regulation, regardless of the economic consequences, to the equally undesirable extreme of trying to maximize economic growth while ignoring environment, safety, and other social concerns. Rather, we need to rethink the whole gamut of government regulation of business as part of a comprehensive economic reform strategy.

Similarly, while I can restrain my inherent enthusiasm for simply cutting tax rates, I believe that simultaneously altering the fundamental structure of the government's revenue system can contribute in highly desirable ways to strengthening the overall economy. Likewise, substantially shifting the composition of government expenditures to favor investment over consumption can help quicken the economic growth rate in a sustainable fashion.

I readily agree that the approach I am presenting will not be an easy strategy to achieve. However, accomplishments along these lines of structural reform will be far more lasting than merely tinkering with the conventional dials of macroeconomic policy.

Shifting the Composition of Government Spending

Let us start with the opportunities for reforming government spending. Voting to approve the general idea of a balanced budget is only a start on the path of fiscal sensibility. The really tough job is to make the specific spending cuts. Few objective criteria have been developed to guide that effort. My suggested guide is to concentrate on reducing or eliminating expenditures that hurt the economy. Inefficient public sector programs represent a deadweight loss to the economy. They produce lower benefits than if the same funds were invested in private activities that meet the test of the marketplace.

Let us assume that we have the duty of preparing guidelines to assist the Congress in this arduous assignment. The most popular formula — eliminating waste, fraud, and abuse — is not adequate to the task. Of course, there are numerous individual examples of fraud, waste, and abuse, however we define those terms. The reports of prisoners who illegally receive social security checks are surely upsetting. So are the stories of companies trying to sell the government shoddy products. These situations should be dealt with severely, but that is just a small start.

Here are five fundamental guidelines for serious budget cutting:

The first is to focus reductions on the large consumption part of the federal budget rather than the small investment component. Such a change would curb the tendency for deficit financing to be a powerful mechanism for converting private saving into public consumption. On occasion, the federal government actually does make worthwhile investments. Some outlays for education help the recipients achieve careers in which their added incomes generate added tax payments that more than repay the government's original investment.

Alas, such examples of effective federal investments are rare. Virtually the entire increase in federal outlays since 1980 has been in the form of consumption-type spending — aside from interest on the national debt. As a result, consumption outlays dominate the budget. In 1992, federal civilian investment outlays — in education and training, research and development, and infrastructure — were only $83 billion, or 6 percent, out of a total budget of $1.4 trillion. Under these circumstances, large reductions in federal spending would be economically beneficial, because they would almost invariably fall on consumption.

By far, the dominant segment of federal consumption outlays consists of transfer payments or, to use the prevailing euphemism, entitlements. Unfortunately, in the largest such program —

social security — the recipients have been led (or rather misled) to believe that they have earned the money they receive.

The typical beneficiary has contributed only a portion of the monthly check issued to him or her. A key fact overlooked by most senior citizen groups is that the total of such contributions plus matching employer payments plus interest does not begin to cover the monthly benefit payments. The balance is a gift from the working population. While I was still in the White House, I had the audacity to label that gift the economic equivalent of welfare. There were immediately calls in Congress for my impeachment. Ronald Reagan, bless him, ignored such ill-considered responses to telling the truth.

As a private citizen, I feel obliged to repeat that accurate point; there is a large but hidden welfare component in the major middle class entitlements. In the long run, privatization may be the most effective response. Meanwhile, reformers need to face the hard fact that recipients have not earned the annual cost-of-living increase (COLAs) which they now expect as a matter of right. The COLAs violate the insurance principle that, on average, you get what you pay for, and they arbitrarily tilt the federal budget even more to consumption expenditures.

If it is not possible to eliminate the annual COLA payments, a "diet COLA" could be limited to the annual inflation in excess of 2 percent. After all, the average working person is not protected completely from the effect of inflation.

A second guideline is to target the many subsidy programs that provide special benefits to limited parts of the population at the expense of the national taxpayer. Such subsidies inherently divert resources away from their most productive uses.

Contrary to widespread belief, especially in the business community, the word "farm" does not always precede the term "subsidy." Subsidies to agriculture *are* the largest component of the subsidy category. Nevertheless, generous subsidies are also provided to business and labor.

Here, I suggest teaming up with an important interest group often at loggerheads with economists — environmentalists. Many government programs are both economically wasteful and environmentally undesirable. For example, we continue mining for many metals and minerals at a time that the federal government maintains over $6 billion of these same items in a military stockpile that the Department of Defense now admits is not needed. That surplus should be sold on the open market. Those sales would reduce the need for some mining activity which, even when commercially necessary, is environmentally invasive by its very nature.

Other economically wasteful activities of the federal government that are also environmentally unsound include selling governmentally produced electricity — as well as water, timber, and grazing rights — at below-market prices. Eliminating these subsidies would simultaneously enhance the efficiency of the economy and reduce environmental pollution — a great "twofer."

A third guideline is to avoid funding expenditure programs designed to offset problems created by regulation. A more cost-effective way of dealing with the problem is to change the original regulation that created the problem. To maintain the status quo is to ensure fiscal perpetual motion.

A major example of this shortcoming is regulation of the workplace. For years, economists have written about discouraged workers who drop out of the work force because they do not believe suitable jobs are available for them. Government has created a new category — the discouraged employer, discouraged by the host of government impediments to hiring people.

Regulatory and mandated burdens on the employment process are rarely considered in relationship to the expensive array of government programs that offset their adverse affects by trying to increase the supply of workers. Yet the record of these offsetting programs, such as job training, is not heartening. The society would be far better off with a combination of regulatory reform and expenditure reductions. Such a combined effort would reduce the gap between federal income and outlay and eliminate serious inefficiencies in the American workplace.

A fourth guideline is to privatize activities which are properly the responsibility of the private sector. We need to go beyond the useful notion of having the private sector produce items under government contract. Although an improvement over relying on government arsenals, this approach to privatization still leaves to the public sector the determination of how much of the nation's resources should be funneled to the designated activity. Many goods and services should no longer be paid for by the taxpayer no matter who produces them. The extent to which those items are produced should depend on the interaction of market forces.

This is not a simple recipe for cutting services to the public. For example, privatizing the air traffic controller functions of the Federal Aviation Administration would enhance the efficiency of air transportation. The airlines are willing to pay higher fees for a more efficient system than the government now provides. The resultant reductions in congestion and airplane and passenger waiting times would more than pay for the private expansion of the air traffic control system.

A fifth guideline for sensible budget cutting is to use economic efficiency considerations throughout the budget process. The key to success is to enforce this guideline. Benefit-cost analysis has often served to sanctify the pork barrel by overestimating benefits and underestimating costs. The use of basic economic efficiency tests would surely improve the overall effectiveness of government spending and likely lower the aggregate level while contributing to more efficient use of the nation's resources. Here are two examples of what is possible:

1. Charge competitive, market interest rates for all federally provided credit. That one change will quickly reduce the many demands for federally subsidized lending. Under the status quo, numerous borrowers who could obtain credit on their own are given an incentive to seek aid simply because the government charges a lower interest rate than commercial banks and other private lenders. Moreover, the current arrangement encourages the extension of credit to borrowers who do not meet the objective tests of the marketplace.
2. Use the comparable market rates of interest when evaluating proposed federal investment projects. Unrealistically low interest rates result in pulling investment funds from the private sector to lower-yield public projects. By definition, such spending is inefficient and a poor use of the taxpayers' money. Traditionally, these programs are referred to as the "pork barrel," and are an appropriate candidate for a federal diet.

Tax Reform

After more than a year of public debate, it is fair to say that there is no universal agreement on how to reform the tax system. Do we streamline the income tax by shifting to a flat tax? Do we adopt a saver-friendly reform known as the USA Tax? Or do we replace the income tax with a national sales tax? It will take much more discussion and analysis before a specific tax reform emerges with enough support to be enacted. Nevertheless, progress has been made on a broad consensus on the direction of change.

The most widely held conclusion is the notion that the tax system is unfair and too complicated. And, when we step back from the mass of specific provisions, it can be seen that the Internal Revenue Code, with its heavy dependence on income taxation, depresses the economy.

There are several key arguments that economists offer for shifting the base of taxation from income to consumption. Consumption-based taxes put the fiscal burden on what people take from society — the goods and services they consume — rather than on what they contribute by working and saving, as do income taxes. Thus, under a consumption-based tax system, saving — and investment — is encouraged at the expense of current consumption. Over a period of time, the society is likely to achieve higher levels of saving and consumption, because the added investment, by generating a faster growing economy, will lead to a bigger income "pie" to be divided among the various participants in economic activity.

A constant theme voiced by tax reformers is the need for increased incentives for saving, capital formation, and economic growth. Under a consumption-based tax, the incentives would be very favorable: the basic way to cut tax payments — legally — would be for individuals and families to save more and for companies to invest more. By increasing the amount that we save and invest, a shift to consumption taxation would augment the forces that create the formation of capital and make possible a more rapidly growing economy.

Combining general tax cuts with comprehensive reform would have special charm. Any reform, no matter how carefully drafted, is bound to generate losers as well as winners, thus reducing the chances of enactment. In contrast, combining reform and rate reductions, for example, will result in more winners and fewer losers, brightening the prospects for the reform being carried out.

The various plans for tax reform are not interchangeable. Each comes with its own set of advantages and disadvantages, but I will spare you a recital of that sleep-inducing detail. Nevertheless, compared to the existing tax structure, any of the three alternatives is simpler and all of them would encourage saving and investment and result in a faster rate of economic growth. All are variants of consumption taxes and several would provide immediate expensing of investment. Just as there may be more than one path to salvation, there is more than one approach to tax reform that can achieve the public's expectations.

Reforming Government Regulation

Although no regulatory agency has been given the express mission to depress the economy, many of their actions have that undesirable effect. The popular view of regulation is wrong. It is not a contest between the "good guys" (government and the consumer) and the "bad guys" (business). The reality is that the consumer is at the receiving end of the benefits as well as the costs generated by government regulation. Business is the middleman (or woman).

The pervasiveness of regulation becomes apparent when we look at the impact on the typical company. Each box on its organizational chart has several government agencies that are counterparts: Environmental Protection Agency (EPA) and construction of new facilities, Occupational Safety and Health Administration (OSHA) and the workplace, Equal Employment Opportunity Commission (EEOC) and human resource policies, etc. Each of those regulators is heavily involved in the company's internal decision making. So are CFTC, CPSC, DOC, DOD, DOL, FAA, FCC, FERC, FMC, FTC, ITC, NHTSA, NLRB, NRC, OFCC, PBGC, SEC, and USDA.

The impact of governmental rule makers is in one predictable direction: to increase the firm's costs, and reduce the resources available to produce goods and services for the customer. Consider what it takes to locate a new factory. A company must obtain approval from dozens of agencies at three or more levels of government. A single "no" anywhere along the line can halt years of planning and investment.

The Shoreham nuclear powerplant on Long Island is a good — or really terrible — example of the economic waste that results. The multimillion-dollar plant was built after obtaining all the required approvals for construction. But the company could not operate the facility because the state governor refused to give the final approval — citing reasons that were well known before construction ever started. The victims extend far beyond the nuclear industry. The companies and residents of New York State now suffer extremely high costs of electricity.

Even when the regulators say yes, the paperwork burden alone is staggering. It takes approximately 55 million hours each year just to work up the reports required by federal environmental statutes — at an estimated annual cost of $2.9 billion. To get a feel of the "opportunity cost" of these clerical chores, that sum is more than the annual budget of the National Science Foundation.

Regulation also reduces the flow of innovation because so many government regulatory agencies have the power to decide whether or not a new product will go on the market. For example, the major obstacles to the development of a new biotechnology industry are not financial or technological, but regulatory.

Higher regulatory costs also erode the competitiveness of American companies struggling in an increasingly global marketplace. Compare the cost of cleaning up a hazardous waste site in the United States and Western Europe. Our average of $30 million per site compares to $1 million in the Netherlands and $1 million to $5 million in the United Kingdom.

The benefits of regulation should not be overlooked. But it is too generous to assume that every regulation is effective. We must ask ourselves three serious questions: What benefits does the regulation produce? Are the benefits worth the costs? Is there a better way?

Regulators tend to forget that usually competition is the most effective way of protecting the consumer. Deregulation of interstate trucking, for example, has resulted in 30,000 new businesses entering the trucking industry. The heightened degree of competition has forced sizable reductions in the cost of trucking which ultimately shows up in lower prices of the items that move by truck.

When government does regulate (as in the case of environmental pollution), it should make the maximum use of economic incentives. To an economist, the environmental pollution problem is not the negative task of punishing wrongdoers. Rather, the challenge is the positive one of changing people's incentives so that they voluntarily modify their behavior. People do not pollute because they enjoy messing up the environment, but because it often is cheaper or easier than not polluting.

What about the existing array of command-and-control regulation? Benefit/cost analysis can help to make sure that any given regulation does more good than harm. Of course, many federal agencies already prepare that type of economic analysis before issuing a new regulation.

However, the entire process of executive branch review of proposed regulations is reminiscent of locking the stable after the horse has departed the premises. Frequently, the agency is stuck with trying to come up with the most cost-effective way of writing a regulation that should not be issued in the first place. Each congressional committee should do a benefit-cost analysis before it takes action on a proposed regulatory statute. Regulatory barriers to innovation should be prime candidates for reform and modernization. Candidates for such judicious pruning — I do not advocate using the meat axe — include the EPA, the FDA, and a host of agricultural agencies.

Regulation is properly viewed as a hidden tax on production of goods and services in the United States. Given the current estimate of compliance cost of $600 billion a year, if sensible reforms could reduce those outlays by 10 percent, we would have the benefits of a $60 billion tax cut!

Conclusion

Experience teaches us to beware of simple answers to complex questions. There is no quick cure to the slow growth of the American economy. Nevertheless, an extensive array of expenditure, tax, and regulatory reforms could shift the American economy to a sustainable higher growth path. Yet, as we have learned from experience, carrying out needed economic changes requires more than developing attractive new programs. It also means making a continuous stream of hard choices. Aye, there's the rub.