President Clinton and the Economy

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I believe this session should be a joint session with the Modern Language Association. President Clinton and his helpers have contributed much more novelty to the rhetoric of economics than to economic policy or standards of living.

Here are some examples of Clintonenglish. Investment is any expenditure that the administration favors. In the first Clinton administration budget proposal, investment included $9 billion for food stamps, $9.5 billion for AIDS and women’s health, $20 billion for the earned income tax credit. There were a host of other programs that contribute nothing to the increase in knowledge, training and physical capital that economists call investment.

Other examples: mandatory health care payments are called premiums to avoid the T-word; price control and regulation is called managed competition; tax increases go into a deficit trust fund, and expenditure switching is called reinventing government. Anything the President does not like is unfair.

Enough. Economics is a serious subject. There is more at stake than abuse of language.

When President Clinton took office, the U.S. economy faced three main problems on my weighting scheme. First, the investment/consumption balance had shifted toward consumption in the last twenty years. This shift was encouraged by regulatory, tax and transfer systems that are biased toward consumption. As a result we invest less than the unconstrained optimum, consume more, and save less. Clinton’s programs worsen this balance.

Second, partly as a result of the reduced rate of investment in physical and
human capital, productivity growth has slowed from the historic 1-3/4% average to about half that rate. That is why wage growth has slowed. Adding to the problem of wage growth is a tax system which biases employers and workers toward the choice of non-wage benefits. Many Clinton programs will reduce real wages.

Third, many of the products of the public educational system are insufficiently literate and numerate to work in manufacturing and some service industries. The result is a widening spread in the distribution of income. The market demand for skilled workers has increased relative to the demand for unskilled, raising relative wages. Many Clinton programs spread the income distribution.

The administration's budget policy is a triumph of the politics of redistribution over a rational policy for economic growth. The architects of this policy don't seem to know that, just as you can't tax boat buyers without hurting boat builders, you can't tax saving without hurting investment and living standards.

The Clinton administration and the Congressional Democrats adopted a budget that was presented as a deficit reduction plan. There is not much reason to believe that without some expenditure reduction or higher tax rates the cyclically adjusted budget deficit will be lower in 1997 or 1998 than it is at present. Even if it is reduced, economists want to ask whether the revised expenditure and tax plan in the new budget increases efficiency and wealth by removing some of the biases against saving and investment or by shifting resources to more productive uses.

The answer is no. The principal changes in resource use are cutbacks in defense spending and increases in spending for entitlements and transfers. And the $240 billion permanent tax increase falls on those who save the most. The new tax law has the biggest percentage increase in the top individual tax rate since 1932. The income tax and the $29 billion additional medicare tax reduce work effort.

Now that the budget has passed even administration economists, like Alan Blinder, recognize that the administration's aim is expenditure switching, not deficit reduction. One reason is the costs of any comprehensive health care program that is

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1In a speech at the American Enterprise Institute, December 7, 1993.
likely to pass, but the main reason is the political decision to allow transfer payments, particularly the so-called entitlements programs, to continue growing. The Clinton health program, if adopted, will greatly increase the growth of entitlements and consumption.

Our job as economists is to explain not complain. Optimal tax theory does not give much guidance about past or current tax policy. Political economists have many explanations for the growth of transfers and tax rates in all democratic countries. Prominent among the explanations are the median voter model, political ideology, the iron triangle, and diffused costs and concentrated benefits. The recent budget is so strongly redistributive that we can test the median voter model using data showing the additional taxes paid by each Congressional district. The data show (1) dollars of income and medicare tax increase and (2) the tax increase for each district relative to the median district. The median voter model implies that districts above the median should generally vote against the tax, and districts below the median should generally vote in favor. More people in relatively poor districts gain from increases in the earned income tax credit and other increased transfers and relatively few voters pay more taxes.

The experiment is complicated by two factors. The Republicans decided to vote as a bloc against the budget. And the issue was presented as (and called) a deficit reduction bill. Despite Robert Barro's efforts, deficit reduction may have ideological or emotional appeal to some voters, or deficits may have some aggregative or distributional effect.

The budget passed the House by a vote of 218 to 216 (one seat was vacant at the time.) Of the 218 voting yes, 127 (58%) came from districts with incomes below the median. For the no votes, the result is reversed; 59% of the 216 negative votes came from districts below the median. This result gives modest support to the median voter

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2 The data were prepared by the U.S. Treasury. They show the dollar cost of increased income and medicare taxes over five years and the size of the payment relative to the median. See "The States and Districts Hardest Hit by the 1993 Tax Increase", Washington: Heritage Foundation, November 24, 1993.
hypothesis. The result includes the negative votes of all Republican members; 65% of the Republicans represent districts with income above the median.

In the fifty wealthiest districts in the country, the vote was 32 against the budget and 18 in favor. Only 1 of the negative votes is from a Democrat. Party affiliation, ideology, or the President’s promises and arm twisting, or some other explanation appear to have had an important influence on the vote.

Notwithstanding all the rhetoric about the budget deficit, CBO estimates of the Clinton economic program leaves the 1998 budget deficit relative to GDP about where it was when President Reagan left office. The main differences are first that the deficit ratio was falling under Reagan (but not Bush), and it will rise after 1997, and second the Clinton deficit projections do not allow for the change in taxpayer behavior in the face of a 37% increase in the top marginal tax rate. Under President Bush, real spending for social programs intended to benefit children, education, nutrition, etc. increased 43% from FY 1989 to FY 1993.3 These are investment programs in Clintonenglish. These programs have not been controlled and will continue to increase, shifting resource use toward consumption.

Let me say a few words about Clintonarithmetic. Clintonarithmetic claimed $100 billion in budget reduction from reinventing government. On further examination it turned that most of the reductions had been used previously as part of deficit reduction or to pay for health care costs. Clintonarithmetic claimed $500 billion budget reduction. Of course, they neglected to say that, for the first time, they used a gross number. When new spending is removed, the number falls to about $300 billion.

The precision of Administration estimates is startling. Candidate Clinton promised to create 8 million jobs by 1996. Guess what? On July 23rd, the Chairman of the CEA denied all economic analysis by showing that the Clinton budget program - mostly tax increases - would create just that many jobs. She was even able to announce how many would be created in each state. Economists should be concerned when CEA economists are politicized to this extent.

Health care is the administration's second major initiative. The candidate and the administration worked hard to promote the idea that there is a crisis. I believe there is no crisis. There are three main issues on the cost side. First, steady increases in technology have improved the quality and cost of medical services. Second, previous administrations imposed price controls on medical care paid for by government. The controls distort resource allocation and incentives for doctors and hospitals. They also shift the excess cost to the private insurance system and the public. Third, neither patients nor doctors have much reason to pay attention to cost.

The administration proposes to reduce cost by increasing demand and reducing supply. The increase in demand comes from many sources not the least of which is the introduction of adverse selection, called community rating. Economists try to avoid adverse selection, not subsidize it or invite it. People who drink, smoke, or take drugs will pay the same fees as those who exercise, eat a healthy diet and live a clean life. The reduction in supply comes from the proposal to consolidate hospitals and from the likely retirement or withdrawal of doctors deprived of the opportunity to work outside the government system.

Since the proposed system requires community rating, private insurers will have to offer the same prices and terms to everyone. This will make it costly to obtain supplemental insurance to cover risks not well covered in the basic package. Again, this harms consumers.

I leave analysis of the details to others. A basic point should not be lost. Government cannot provide health care. It takes real resources such as capital (hospitals, operating rooms, equipment), labor (doctors, nurses, technicians), and intermediate products (medicines, bandages) to produce health services. All that government can do is redistribute the cost. The Clinton program does that and imposes excess burden on most consumers.

The problem is that past efforts to redistribute costs and control prices have created many of the problems in the present system. Economists recognize that some redistribution may be appropriate to remove externalities, and political economists recognize that redistribution of health costs is unavoidable in democratic countries.
The problem is to redistribute in the least harmful way.

In my opinion, the Clintons' health care plan will not control costs with or without price controls. Increased demand and reduced supply will yield higher costs and less quality. Price controls will further distort allocation and further reduce quality. Absence of any experience rating will prove costly. The system will not work. Fortunately, in the judgment of many analysts, the Clintons' program will not be approved in its present form.

The Clinton administration promised to produce jobs. Job creation is a macro problem but, with a minimum wage, high transfer payments, and increased regulation, some micro programs reduce employment especially short-term. The health care program and increased regulation reduce employment in the short-run and reduce real wages in the long-run.4

I would be remiss and partisan if I failed to praise the Clinton administration's positive accomplishments. The most important of these are NAFTA and GATT. NAFTA is loaded with protection, and I am sure GATT is too. But some of the protection is phased out over time and probably would not be without these agreements. And, wonder of wonders, the infamous multi-fibre agreement and the sugar quotas will go, and dispute settlement procedures will be strengthened. Not bad for an administration that came to office saluting the banner of managed trade.

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