What Congress and the President Should Do

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Contrary to most reports, the economy is recovering, albeit slowly. It would be a mistake to act on the assumption that we are facing a deep recession or the start of another great depression. In retrospect, the recession will be seen as relatively mild. Our current unemployment rate at 6.8% of the labor force is below the rates in many countries including Britain (8.7%), Canada (10.3%), France (9.7%) or Italy (10%). Germany has had a boom for several years, but its unemployment rate at 6.3% is only slightly below ours.

Economic forecasts are often wide of the mark. We should not add to our current problems by basing policy action on forecasts about the speed of the recovery. The best forecasts of economic growth have an average error about equal to the average rate of growth. A comprehensive study of forecast errors shows that forecasters cannot distinguish on average between booms and recessions next year or even next quarter. Basing policy actions on forecasts is likely to produce errors of timing.

The Main Problem

My advice is not to stand still but to act boldly, not just for next quarter or next year but for the rest of the decade and beyond. Although there are regions of the country with serious distress, our main economic problem as a nation is not the current relatively mild recession; it is more accurately reflected in the slow average growth of per capita income for the past twenty years. Median family income in constant dollars was $34,213 in 1989, before the recession, only $557 higher than median family income in 1973. Average compensation per hour, adjusted for inflation, increased only 3% in the 16 years ending in 1989 after increasing more than 30% in the previous 16 years.

Scholars can bring many explanations of the changes in family income, compensation, and income distribution. Changes in family structure, labor force participation rates, demographics and other factors influence these numbers. Changes in tax policy and regulation also have effects. Because tax policy and income distribution are central to politics, we continue to argue or debate about the policies of the 1970s and the 1980s as part of election year politics. A better alternative is to work on the main problem.
I believe that the principal reasons behind the slow growth of middle class incomes and decline in their income share are the slow growth of productivity and the increased returns to higher education and schooling in the 1980s. Slow productivity growth held down growth of average incomes. Increased returns to higher education raised the relative incomes of the top 20% of the income distribution, spreading the distribution of income both before and after taxes. Middle income groups have experienced slower income growth principally because productivity has slowed.

Proposed Solutions

Several of the bills introduced in this committee seek to change the income distribution by reducing taxes on middle income families in one way or another. Some propose temporary reductions. Experience shows that reductions known to be temporary would be used mainly for debt reduction or other forms of saving and would have little effect on spending. Some propose permanent reductions paid for by higher taxes on upper income groups. The net effect of these changes on total spending is likely to be small, and it is uncertain whether they would raise or lower spending.

More importantly, these proposed tax changes reflect a misperception of the problem. If growth of middle class incomes is lagging, it is because productivity is lagging. Tax cuts that get the middle class to spend more may give them some temporary good feeling. Increased sales and purchases would encourage some increases in investment, thereby improving tools and equipment and perhaps increasing productivity. The problem is that these effects would be small. Domestic output is only about 5% below the level of capacity utilization achieved in a boom. And a significant part of the increased consumption spending would be on imported goods.

To raise incomes permanently for the middle class, and all other productive people, we, as a nation, must raise productivity to increase output and incomes. There is no magic pill or quick fix to do that. Productivity growth in the aggregate depends on investment in physical capital and in education. People with better tools and equipment produce more. People with better education think of ways of improving either the tools or the way they are used.

One of the main reasons for the faster growth of incomes in the highest income groups is that education is not only pleasant for many, it is also profitable. The highest income groups include professionals, managers and others who have invested in their own education and availed themselves of the opportunity to improve their knowledge and skills.

Tax policy can increase productivity by increasing investment. To get more investment as a society, we have to increase the after-tax, risk adjusted real return to investment. Government could help by replacing taxes on income or output with taxes on spending. That would act like a jumbo IRA removing taxes from saving and finance productive investment. The short-term effect on the economy during the adjustment could be negative, but the long-term effect would be positive as productivity increased. Substitution of a spending tax for the personal
income tax would leave the budget deficit unchanged. Over time, higher investment would raise productivity, income, spending and tax revenue.

An alternative would be to encourage investment by allowing businesses to take all investment spending as a deduction from income. This amounts to giving a permanent investment credit. This immediate write off of costs would help to rebuild some of our capital intensive industries and encourage development of new capital intensive industries. As productivity rose, incomes would rise. Permitting businesses to expense new investment would reduce the present bias in the tax system against investment. The jobs that would be created would have higher productivity, thereby raising the growth rate of family income and weekly earnings.

A temporary investment tax credit would increase current investment partly, and in my judgment mainly, by shifting planned investment forward from future years. Spending and output would increase, but the effect on long-term productivity growth and income would be small.

The permanent program I propose would help the economy in 1992, but its benefits would be felt over a longer period. Again, our main economic problem is not short-term. For more than 100 years, mild recessions have been typically followed by gradual recoveries. We have had a mild recession, and we are having a gradual recovery. When the recovery is complete, the slow productivity growth of the past twenty years will continue. The administration and the Congress should opt for the long-term solution, not the quick fix.

**What About the Deficit?**

Net investment in producers’ durable equipment was about $70 billion before the recession. Corporate income tax payments and accruals are a larger sum, so the potential loss of tax revenue from expensing costs of net investment is $70 billion or more. This is slightly more than 1% of GNP in 1992. The budget deficit would rise. How should we pay for it?

I propose that the 1990 budget agreement be revised to permit future reductions in defense spending, and in the growth of other spending, to offset the loss of current revenue. There are two principal reasons. First, all of the tax reduction will finance productive investment, so future taxable income will increase. Productivity increases will raise per capita income, expanding the tax base. Second, the economic position of the budget (as conventionally measured), unlike the accounting position, has not been in deficit. It is at or near surplus. And it is the economic position that matters for the well-being of the economy.

For a decade or more, we have heard cries of alarm about the budget deficit and predictions about the terrible fate that will be ours if we persist in our profligacy. These predictions have not come true. One reason they may have failed is that the alarmists have used the wrong numbers.

Economic analysis tells us that there are two principal budget numbers to watch. One is the primary budget deficit or surplus; the other is the ratio of government debt to GNP. If we use conventional measurements (an uncomfortable but necessary
step), we find that neither the primary budget position nor the ratio of debt to GNP justifies the alarmist position.

The primary budget excludes interest on the national debt (about $200 billion) and the financing of the thrift industry bailout (about $66 billion on budget in fiscal 1991). Interest payments are excluded because they are a pure transfer without economic effect. The real losses of the thrift industry mainly occurred in the past, and the liability was incurred years ago. Issuing bonds now to pay for these losses has no economic effect. The primary budget has been in surplus in recent years and, according to the Congressional Budget Office (CBO), will be in surplus again after a deficit of about $40 billion in fiscal 1992 resulting from recession and slow growth this year.

Interest payments and payments for the losses on the deposit insurance fund are excluded from the primary deficit, but they may be financed by selling debt. The ratio of debt to GNP may rise. A persistent rise in this ratio is a signal that the economy is not growing fast enough to service the debt; unless policies changed, the debt would grow without limit. CBO projects that this will not happen. They estimate that the debt to GNP ratio will level off at about 48%. For comparison, 48% is far below the ratio in the United States during the 1950s, in Italy, Ireland and Belgium now, and not far above the ratios for Germany or France.

Many questions can be raised about the reported numbers. If we accept the budget numbers as grossly accurate for current purposes, they tell us that the administration, the Congress and the public should not be deterred from acting responsibly to solve our economic problem. It is responsible to borrow to increase productive investment and raise living standards.

Conclusion

Current opinion polls show that a majority believes that the future will be worse than the present, that our children will be poorer than we are. Pessimism of this kind has increased over the years, perhaps reflecting the reality of slow productivity growth and the slow growth of incomes.

Many of the proposals before your committee try to stimulate consumer spending or transfer income to the middle class. A temporary program will not persistently raise income. However, increasing the productivity growth rate by 1/2% a year would add $25 to $30 billion to GNP in the first year that productivity increases and larger sums in subsequent years.

Our major competitors have in place policies to raise their productivity and standards of living. Following the merger with East Germany, Germany has run large budget deficits relative to their past performance and relative to their GNP. Most of their increased spending is for investment in plant, equipment and infrastructure. These expenditures will in due course increase productivity. Output will boom and the competitive position of the German economy will improve. In 1987 Japan shifted taxes from capital to consumer spending. Investment boomed and will be followed by a rise in productivity and living standards. Japan's competitive position will improve also.
To raise our productivity and income we must improve our education and training and increase our investment rate permanently. Action by Congress and support from the administration to encourage more investment is one part, but an important part, of this program. The program will have a larger effect on domestic income if it is financed by domestic saving. But productivity will increase even if the additional domestic investment is financed by a larger current deficit and increased capital inflow until reductions in defense and other spending offset the revenue loss.

Congress and the administration should opt for growth of income, not a temporary increase in spending. Current popular concern about lagging growth of income is an opportunity to respond to the public's concern about their future and ours.