Promises and Performance

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Promises and Performance

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The public of the western alliance has reason to be pleased. Incomes have risen persistently and living standards dramatically in the past forty years. The principal threat to democratic capitalism has been removed for the present and possibly forever.

Joy and happiness is clearly not the dominant mood. In the major European countries, as in Canada and the United States, there is increasing dissatisfaction with political and economic achievements. The public senses that a gulf has opened between promise and performance. Voters in Germany, France and Italy showed their unhappiness by voting heavily for splinter or extremist parties. Voters in Canada and the U.S. tell pollsters about their lack of confidence in their current political leaders. Perhaps reflecting the mood of the voters, large numbers of U.S. Congressmen give up their seats. As they retire, some use the opportunity to comment on the failures of the political system, its inability to resolve problems, and the constant game of one upmanship. Voters interviewed after the spring primary elections express more than the usual dissatisfaction with all of the candidates.

What went wrong? Why is there so much dissatisfaction? Why now?

Some blame the current recession or slow recovery. Others, particularly in the United States, cite the shift in the income distribution toward the top 10 or 20% and away from the middle class. Still others cite the belief that the current generation will be one of the few in U.S. history to be poorer than its parents. And there are many other proposed explanations.

One difficulty with many of these explanations is that few of them apply to all of the countries where dissatisfaction was expressed through the political process. Another is the number of exceptions, countries in which there is as yet no evidence of
political change. Countries like Switzerland or Austria experienced the same or similar economic condition as their neighbors -- Germany, Italy and France -- without any visible sign of growing dissatisfaction.

The recent United States recession was relatively mild compared to the average postwar recession. It is implausible that a combination of modest recession and modest recovery would produce as much unhappiness as voters and citizens exhibit and the press reports. Until recently, West Germany has been in a post-unification boom with income growth well above the average of the 1970s or the early 1980s. Dissatisfaction there appears to be high also, with complaints about immigrants and the costs of unification prominent on one side and fears of a return of intense nationalism on the other.

Data on income distribution for the United States show more growth among upper income groups than other parts of the population. A widely accepted explanation for part of the shift is the increased premium paid for bachelor and advanced degrees. Comparisons with Canada, Japan and other countries show that some of the same forces have been at work shifting the income distribution in favor of the more educated. The size of the shift is smaller, however, in these countries. The differences may reflect changes in the mix of jobs in different economies or differences in the relative quality of college and pre-college education in the various countries. I can only speculate, since there is not much information on which to rely.

The change in the income distribution may account for some of the dissatisfaction in the United States, but it does not explain the broader pattern affecting several countries. More certain is the fact that, despite repetition, tax changes associated with the Reagan administration are not the sole or principal cause of the change in the U.S. income distribution. The increased return to college and post-college education began in the 1970s before the tax changes were made. And the distributions of household and family income, used in many comparisons, are before-tax measures.

Despite frequent repetition, there is no basis for the claim that upper income groups shifted taxes to the middle class. Comparisons based on changes in tax rates neglect changes in the tax base and other factors affecting tax payments. Such data
have no relevant information about comparative tax burdens. A congressional study shows the opposite to be true. The shares of Federal taxes paid by the top 5% of all taxpayers, and the top 20%, have increased since the late 1970s. The nearly 5% increase in the share of taxes paid by the top 20% permitted reduction of about 1% in the share paid by each of the remaining quintiles.

One factor that is common to the United States, Germany, Italy and France is the gap between government promises and performance. In each of these countries governments have undertaken major programs that are widely regarded as costly and burdensome. Governments promised more than they delivered, and in some instances contributed to unexpected and, at times, undesirable results.

The Public Sector

In the United States, the Johnson administration introduced the Great Society, with promises to provide more fairness, more equality, and a change in the role of government in race relations. In place of a prior government policy that often enforced segregation or ignored the denial of full rights of citizenship to minorities, government accepted responsibility for enforcing desegregation in schools, accommodation, the workplace, transportation and many other public and private spheres.

These efforts succeeded in reducing many overt forms of discrimination against minorities. I believe that measures such as the extension of voting rights and desegregation of public accommodation and the workplace had considerable public support, and this support continues.

A different set of policies attempted to change the income distribution. The “war on poverty” introduced an expanded set of programs to redistribute income. This war was followed by wars on crime, drug addiction and other social and personal problems. These wars often began with much publicity. Presidents committed the nation to programs that, we were assured, would eliminate the particular scourge.

The wars produced not victory but defeat. Between the 1967 and 1993 budgets Federal government spending for education, health care, and income security (other than social security) increased more than 2-1/4 times after adjusting for inflation. These large expenditures have had modest effects at best. Drug usage, and the
crimes associated with drug usage, seem unaffected by government efforts. After some early decline, the poverty rate as measured, has not fallen.

Much of the early success is an illusion. The initial decline in the poverty rate was in part the result of two events unrelated to the war on poverty. Increases in old age assistance benefits raised the incomes of many of the retired above the poverty line. Also, relatively high productivity growth in the 1960s raised incomes across the distribution of income. The effect of the poverty war may have been negative, since higher taxes and higher benefits for not working discourage effort.

Several years ago, Charles Murray reviewed the war on poverty and concluded that, far from being a success, the war on poverty had been counterproductive. By reducing incentives to work, encouraging the breakup of families and birth out of wedlock, Murray argued, the programs' net effect was negative for the recipients. This conclusion was challenged. The outcome of the controversy is remarkable. Murray's critics did not show that he had overlooked or misperceived evidence of substantial progress. Often, a program like Head Start, to help pre-school children, would be claimed as a success, but few if any of Murray's many critics were able to bring evidence showing that the government's efforts had made significant contributions to social welfare.

Although many of the programs failed to produce the results that were promised, they grew in size and cost. By 1990, a representative individual who earned about $46,000 in annual income paid 15% of income, more than $7000, in federal and state taxes net of transfers in cash and in kind. At $94,000, the net transfer was 23% of average income. In 1990, taxpayers paid more than $170 billion for means tested benefits for the poor. (These benefits exclude such large programs as old age assistance and medicare, and unemployment insurance.)

If the transfer programs were supposed to encourage social harmony or personal satisfaction, they failed. Between 1960 and 1975, the homicide rate more than doubled. Other crime indicators rose also. Most crime rates remained in a narrow range during the 1970s. Although crime rates declined in the 1980s, they remained far above the rates reported for the early 1960s. Exceptions are mainly crimes such as rape or child abuse that have received increased attention and may be
reported more fully. Divorce rates show a broadly similar pattern, more than doubling between 1960 and the middle 1970s followed by relative stability until the middle 1980s. Indications of increased social harmony are hard to find.

By the end of the 1970s, voters were willing to try a different approach. President Reagan took office committed to reducing inflation, lowering tax rates, deregulating the economy and increasing growth. Inflation was reduced but not eliminated. Income tax rates were reduced and the tax base was broadened. After a brief spurt, productivity growth resumed its sluggish rate of increase. Another set of promises was incompletely fulfilled.

The major mistake of the supply side tax reformers was to overstate what could be accomplished by tax changes. They neglected that economic progress depends not just on tax rates but on efficient use of resources. They were right to insist that tax reduction can increase incentives. They neglected almost entirely that productivity depends on investment in capital and education whereas on balance government policies favor consumption over investment. They neglected that our educational system is deficient, and that much of the spending for education has little to do with learning. After a promising beginning in the 1970s, most efforts in the 1980s to reform regulation were opposed by Congress and by those who benefitted from the regulations. The Reagan administration was not willing to carry its fight to the public. Efforts to eliminate inefficient and ineffective spending programs were announced but did not get priority. Few spending programs were eliminated, and the major entitlement programs continued to grow thereby shifting resource use toward consumption.

Growth of productivity and real income was not markedly different in the 1980s than in the 1970s. Using these measures, the public would be right to conclude, again, that supply side achievements were less than had been promised, although more positive than many critics allege.

Efficient education and health care systems can contribute to productivity and income. Per pupil costs of education in public elementary and secondary schools are among the highest in the world. Measures of learning are among the lowest in developed countries. Years of talk about an educational crisis or a nation at risk
produced little in the way of reform. Per pupil costs in constant dollars continue to rise. Measures of pupil performance that are available show little improvement. Wide recognition that improved educational quality will raise productivity has encouraged experimentation, often supported by business and other private sources, but reform has been limited and its effects have been small.

Health care costs continue to rise whether measured after adjusting for inflation or as a share of total spending. Part of the increased cost represents improvements in quality, but as much as 15% of the spending is used to pay for the terminally ill who are within a few months of dying. Government has held hearings, studied the problem, used price controls, direct controls on length of service and other stopgaps. Again costs per patient are among the highest in the world. Performance is not.

One of the legacies of the 1980s is the continuing Federal budget deficit. There are many deficiencies in government accounting practice that both overstate and understate the government's fiscal deficit. These are typically ignored in discussion. Congress and the administration promise to reduce the reported deficit and achieve a balanced budget. Under Gramm-Rudman-Hollings legislation, Congress committed in 1986 to reduce the reported deficit to zero in 1991. Within a year, the budget had strayed from its target path despite reliance on creative accounting. Revised targets promised a balanced budget in 1993. Instead the reported deficit soared. After laboring for months, Congress and the administration produced a new program in 1990 that increased tax rates. Spending soared, and the revised projections for future budget balance were soon forgotten.

A recent article notes that to clean up hazardous wastes we spend $1.75 million per cancer case diagnosed. Spending by government is often inefficient, determined, as this example suggests, by those who most effectively organize. The result is wasteful spending that raises doubts about the efficacy of public programs.

Saving and loan problems were one of the most widely discussed economic problems of the 1980s. By the middle of that decade a voluminous literature analyzed the central problem and proposed solutions. Predictions of the number of financial failures were widely circulated by economists working for the regulators and by outsiders. The regulators, Congress, and the administration ignored the problem or
attempted to hide it by using accounting sleight-of-hand and granting forbearance. The cost to the public of this neglect is the largest financial loss ever recorded. Deposit insurance protected depositors from losses and prevented bank runs, but it also contributed to the willingness to take risks that imposed large losses on the depositors as taxpayers.

When college students or their younger brothers and sisters look at old age assistance, they see that here, too, government has promised more than it will deliver. Early retirees received a free ride. Current retirees receive a positive return on their accumulated payments. Future retirees will bear a net cost.

Government in the U.S. is not an efficient or effective provider of health care, education, pension benefits, deposit insurance or welfare. The reason is not obscure. Government is concerned mainly with distributive issues. Who gains and who losses? Who pays and who receives? Efficiency and program effectiveness are typically of less interest to politicians.

Corruption is an additional problem. After I wrote about the saving and loan problem in my newspaper column, I received letters from readers chiding me for failing to discuss corruption. There appears to be a widespread belief that the problems of the banks, BCCI, the thrift industry and other widely discussed losses are magnified by public and private corruption. Research suggests that in the thrift industry, regulatory failure, not corruption, was the main problem.

I am less familiar with the promises made by governments in other countries. To an outsider, however, some of the problems are similar, and public response seems similar in kind if not in detail. The Italian government spent billions of dollars over a 25 year period that was supposed to strengthen or build the economy of southern Italy. There is little evidence of success. Promises to stamp out or suppress corruption and crime achieved little. The cynics believe that much of the money was either stolen or used to increase votes for the principal parties of government.

Separatists are now the dominant party in much of northern Italy. The ordinary citizen of northern Italy opposes many of the transfers financed by taxes and deficits. The appeal of the separatists, who talk of dividing Italy, is an appeal to reduce these transfers, lower tax rates and deficits, and reduce corruption.
In France, the Socialists came to office promising to reduce unemployment, nationalize major firms, allegedly to increase equality and social justice. There is not a single year in which the unemployment rate under the Mitterand governments has been as low as the rate in the last year of the prior administration. The promise to provide social justice by increasing the role of government produced inflation, devaluation, and loss of freedom. Finally, much of the program was abandoned.

Chancellor Kohl promised the Germans quick unification at low cost. He is delivering slow recovery in the East at a cost of nearly $100 billion with more spending to follow. To the ordinary West German, who believes that his own economic achievements resulted from personal efforts, the burden of redistribution seems both heavy and unjust. The former East German sees the relative prosperity of the West and asks for larger transfers.

In each of these countries, the reality is that governments have promised much more than they were capable of delivering. The political response is not recognition of a mistake and correction. Often there is further commitment of resources and higher costs borne by taxpayers. It should not be surprising if many citizens of these countries do not believe that their taxes are spent wisely or well. Of course, government failures are not the only cause of discontent. Immigration, and the prospects of additional immigration, raise social as well as economic concerns in many European countries. But if government had greater credibility, it would be better positioned to address such issues.

The Private Sector

Throughout the recent recession and slow recovery, doom and gloom dominated reporting about the economy. One of the mildest of postwar recessions was described frequently as a depression. Reports of prospective and actual layoffs and job losses throughout the fall of 1991 ignored the relatively constant unemployment rate. That rate signalled that new jobs were being created at about the same rate as job losses. Monthly employment remained in a narrow range; the monthly unemployment rate increased by 1% from December 1990 to December 1991 and about 2% for the recession and recovery to date.
By most measures, the recession was mild, and it ended in the spring of 1991. The slow recovery produced growth of output at about half its average rate. Much of the shortfall in growth is explained by the decline in defense production. Without this decline, output would have grown about 2-1/2% in the last three quarters of 1991. This is not a spectacular rate for the early quarters of recovery but it is close to the historical average growth rate for the U.S. economy.

Sluggish growth is not new. U.S. productivity growth for the past twenty years is less than half the long-term U.S. average. Productivity growth has fallen in many countries, including France, Germany and Italy where voters recently expressed dissatisfaction at the polls.

Increases in compensation (in constant dollars) or living standards depend mainly on productivity growth. The table shows average productivity growth in each of these countries for selected periods during the past 20 years.

Slower growth of income may reinforce dissatisfaction with the political process. But slower growth of productivity and income is found in all industrial countries. Voter dissatisfaction has been evident so far in only a few.

A frequent comment about the U.S. economy points to the lack of "competitiveness." This term is not easy to define. Exchange rate changes adjust for differences in costs. Individual companies may be uncompetitive, but the economy as a whole cannot be. If many industries lose their ability to export or lose home markets to foreigners, exchange rate adjust to reverse the changes or to benefit other industries and firms.

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Source: Annual Report, Commission of the E.C.; CEA.
Nevertheless, complaints about U.S. competitiveness are common. These complaints include statements about our inability to export, the declining share of manufacturing output, and the loss of leadership in markets for new technologies.

Most of these claims are false. U.S. manufacturing output as a share of total output has been in the same range since 1950. Currently, it is near the top of the range or slightly above. The share of exports to total output in 1991 was the highest in the postwar (and possibly the highest in our history). The export share has doubled since the late 1960s. Exports of capital goods excluding autos, in constant dollars, doubled in the last 5 years. These exports are four times the value of the late 1960s. Exports of computers and peripheral parts rose from $11 billion in 1985 to more than $40 billion in 1991.

Growth of exports in constant dollars rose at an average rate of 13.3% for the past five years, and capital goods exports rose at an even higher rate, more than 15% a year. Indeed, rapid growth of exports and much slower growth of imports has brought the trade balance (net exports in constant dollars) from a peak deficit of $155 billion in 1986 to a deficit of less than $10 billion in fourth quarter 1991.

Yes, there are exceptions. We import many consumer goods and lots of oil. It will perhaps surprise many people to learn that our balance of auto exports to auto imports has been negative since 1968, long before many began to preach gloom and foreboding and long before proposals for industrial policy became popular.

It is true, also, that we import many automobiles and that domestic production of autos and parts has declined relative to total output. At its peak in 1962-67 U.S. value added in the production of autos was about 4% of total output. Most of the decline in auto production relative to total output occurred in the early 1970s. For the five years ending in 1991, auto output was about 2-1/2% of total output, down 0.1% from about 2.6% in the preceding five years. As a nation, we have increased auto production at about the average rate of output growth.

One reason that the share of auto output has stabilized is that foreign producers in the U.S. have expanded as domestic producers have contracted. Since the measure of output is value added, foreign production counts only to the extent that it is
"made in America." Of course, many of the foreign factories are not unionized. The United Auto Workers, like the United Steelworkers have lost members. That perhaps explains why both unions favor restrictions that might benefit them, at least for a time, but would impose a burden on the rest of us.

This should not suggest that we cannot do better. However, the path to "better" does not run through government bureaus, planning agencies, or industrial policies. It will come, if it comes at all, by actions that increase productivity such as increasing investment, raising the quality of education, improving product and service quality, removing burdensome regulations that increase the cost of controlling pollution, providing health care, marketing new products, or improving safety.

Productivity in the U.S. economy rose an average of 2.3% for the first 70 years of this century. For the last twenty years, it rose at half that rate or less. That is one reason for current dissatisfaction about the economy. We stand a better chance of getting back to the old rate if we reject protectionist pleading for industrial policy and return to the practices that worked for the 70 years of higher average growth -- less regulation and less costly regulation, more and better education, more investment and more productive investment, higher saving rates and a reliance on markets instead of officials to determine how resources are used.

The challenge for the economy is to bring future performance up to the level of past performance. Unless the political sector reduces the excess burden of regulatory and redistributive policies and stops favoring consumption spending over investment in human and physical capital, I do not believe that challenge will be met.