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U.S. ECONOMIC POLICYMAKING

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JOINT ECONOMIC COMMITTEE
CONGRESS OF THE UNITED STATES

ONE HUNDRED FIRST CONGRESS

FIRST SESSION

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CONTENTS

WITNESSES AND STATEMENTS

TUESDAY, SEPTEMBER 12, 1989

	Page
Hamilton, Hon. Lee H., chairman of the Joint Economic Committee: Opening statement	1
Gramley, Lyle E., senior staff vice president and chief economist, Mortgage Bankers Association of America, and former member, Federal Reserve Board and Council of Economic Advisers	2
Rivlin, Alice M., senior fellow, the Brookings Institution, and first director, Congressional Budget Office	18
Stein, Herbert, senior fellow, the American Enterprise Institute, and former Chairman, Council of Economic Advisers	31

SUBMISSIONS FOR THE RECORD

TUESDAY, SEPTEMBER 12, 1989

Gramley, Lyle E.: Prepared statement	6
Rivlin, Alice M.: Address entitled "Economics and the Political Process"	21
Stein, Herbert:	
Prepared statement	35
Article entitled "America's Second Fiscal Revolution"	45

U.S. ECONOMIC POLICYMAKING

TUESDAY, SEPTEMBER 12, 1989

CONGRESS OF THE UNITED STATES,
JOINT ECONOMIC COMMITTEE,
Washington, DC.

The committee met, pursuant to notice, at 9:30 a.m., in room 2247, Rayburn House Office Building, Hon. Lee H. Hamilton (chairman of the committee) presiding.

Present: Representatives Hamilton, Obey, Scheuer, and Snowe.

Also present: Joseph J. Minarik, executive director; David R. Malpass, minority staff director; and Chad Stone, Jim Klumpner, and Chris Frenze, professional staff members.

OPENING STATEMENT OF REPRESENTATIVE HAMILTON, CHAIRMAN

Representative HAMILTON. The Joint Economic Committee will come to order.

This morning we meet to examine how economic policy, both budget and monetary policy, is made; and we are very pleased to have with us three distinguished witnesses: Lyle Gramley, a former member of the Federal Reserve Board and of the Council of Economic Advisers, who is now senior staff vice president and chief economist for Mortgage Bankers Association of America; Alice Rivlin, the first Director of the Congressional Budget Office, and now a senior fellow at the Brookings Institution; and Herbert Stein, who is a former Chairman of the Council of Economic Advisers, and now a senior fellow at the American Enterprise Institute.

We welcome each of you to the hearing this morning and appreciate very much your coming. I am looking forward to your testimony.

I notice you have prepared statements. Those prepared statements, of course, will be entered into the record and any attachments to them that you would like to include we would be very pleased to receive.

So we will begin the testimony with you, Mr. Gramley, and just move across the table from my left to right.

We welcome you, sir.

STATEMENT OF LYLE E. GRAMLEY, SENIOR STAFF VICE PRESIDENT AND CHIEF ECONOMIST, MORTGAGE BANKERS ASSOCIATION OF AMERICA, AND FORMER MEMBER, FEDERAL RESERVE BOARD AND COUNCIL OF ECONOMIC ADVISERS

Mr. GRAMLEY. Thank you, Mr. Chairman. I am very happy to be here to give you my thoughts on the economic policymaking process. I'm going to read just excerpts of my prepared statement to save time.

I spent a large part of my professional career in the Federal Reserve System. Given that fact, perhaps I can be most helpful by focusing my testimony principally on monetary policy decisions, how they relate to fiscal policy decisions, and how they affect the achievement of the Nation's broad economic objectives.

To summarize, I do not see any major deficiencies in present procedures for making monetary policy, or for coordinating fiscal and monetary policies. I will argue, also, that reducing the independence of the Federal Reserve by putting the Secretary of the Treasury on the Federal Open Market Committee—FOMC—as H.R. 2795 provides for, would do a good deal of harm.

I certainly would agree that there is room for improvement in economic policymaking. As I look back over the past 25 years, several major macroeconomic policy mistakes stand out prominently.

They include the inflationary financing of the Vietnam war, the effort to bring down inflation with mandatory wage-price controls in the early 1970's, the excessively stimulative monetary and fiscal policies of the 1970's and the enormous Federal budget deficits of the first half of the current decade. I know of no reason to think that those policy errors stem from deficiencies in policy procedures. Rather, they stemmed purely and simply from bad policy judgments.

Let me say a few words about the ultimate objectives of monetary policy. We all know that money and prices are related to one another, more closely in the long run than in the short run. Indeed, most economists would agree that, in the long run, what happens to the stock of money principally determines the level of prices and the rate of inflation, and not the level or growth of real output.

Let me relate this theoretical proposition to reality with a concrete example. Between the early 1960's and the late 1970's, the U.S. economy went from price stability to double-digit inflation. There were many contributing factors to the wage-price spiral—such as the way in which the Vietnam war was financed, the suppression of actual inflation by mandatory wage-price controls during a period when monetary and fiscal policies were both highly stimulative, and the two oil-price shocks of 1973 and 1979.

However, none of those factors, either alone or in combination, would have led to double-digit inflation if the Federal Reserve had not permitted an excessively rapid growth of money and credit.

If monetary policy largely affects the level of prices, and only the level of prices, over the long run, then it would seem to make sense for the longrun objective of monetary policy to be reasonable price stability, and that, I believe, is the Federal Reserve's present understanding of its principal role in economic stabilization policy.

To be sure, Federal Reserve officials, no less than Members of Congress, would like very much to see an increase in our national saving rate, a decline in real interest rates, a higher proportion of our nation's resources devoted to capital formation, a higher growth rate of productivity and potential GNP, and a real value of the dollar in exchange markets that leads to reduced merchandise trade and current account deficits. These variables, however, are largely beyond the influence of monetary policy over the long run.

By contrast, fiscal policies can have substantial long-range effects on these variables. If economic performance in these respects is unsatisfactory over extended time periods, Federal fiscal and budgetary policies may be able to help. It is unlikely that monetary policy will be able to make a positive contribution other than that of maintaining reasonable price stability.

I am a strong supporter of maintaining the independence of the Fed from the administrative branch of government. Putting the Secretary of the Treasury on the FOMC would, in my view, be a mistake. Such a step would put the administration in the thick of monetary policy decisions, and would politicize virtually every such decision the Fed makes.

We have a pretty good idea, moreover, in which direction the administration would be pushing the bulk of the time judging by the administration's recent carping that the Federal Reserve has been running a monetary policy that is too tight; that is, giving too much attention to fighting inflation and not enough to maintaining adequate growth.

Putting an administration official on the Federal Open Market Committee would force the administration to take more responsibility for the course of monetary policy, but would it produce a better monetary policy? If the pressure of the Secretary of the Treasury on the FOMC caused the Fed to focus more on the short-run effects of its policies, and less on the longrun impact, the likely outcome over the longer run would be higher inflation.

Independence from the administrative branch of government does not mean that the Fed should have the freedom to do whatever it pleases in the conduct of monetary policy. In a democratic society, people ought to be able to choose, ultimately, what kind of monetary policy they want, however good or bad that might be. That means that the Federal Reserve ought to be under the control of the Congress, as it is, and that it should report to the Congress regularly, as it does, on what it has done in the past and what it plans for the future.

Let me turn now to some comments on coordination of monetary and fiscal policy. As you know, the reporting requirements of the Humphrey-Hawkins law are the principal mechanism for ensuring that monetary and fiscal policies work harmoniously together. Would additional formal mechanisms help to provide a better economic policy environment? Past experience does not provide much support for this view.

There are two cases during the past 25 years in which a deliberate effort was made by the Federal Reserve and the administration to work out a more satisfactory mix of policies. The first was in 1968. Chairman William McChesney Martin sought to persuade President Johnson that a tax increase was essential to finance the

Vietnam war; he indicated that monetary policy would ease if fiscal policy were tightened.

In the summer of 1968, President Johnson imposed a 1-year surcharge on individual and corporate income taxes. Having given his promise, Chairman Martin eased monetary policy. Since the income tax surcharge was temporary, however, it had little effect on private aggregate demand. The result of the changed policy mix, consequently, was the worst of all possible worlds. Fiscal policy did not become meaningfully tighter and monetary policy became easier.

Another abortive attempt occurred early in 1980 when the Carter administration gave the Fed the authority to impose direct credit controls under the Credit Control Act of 1969. The Fed was not very enthusiastic about the idea, but it felt it could not ignore the President's wishes in this matter.

Working together, the Federal Reserve and the administration put together a set of credit controls that had far harsher effects on consumer spending than anyone had anticipated. The credit control program was a major contributor to the sharp but short recession of 1980, and it was dismantled by the Federal Reserve at the earliest opportunity.

Coordination of monetary and fiscal policies is obviously not an end in itself, but a means to a better economic performance. If my understanding of how monetary and fiscal policies work is correct, mechanisms of coordination to accomplish that objective would need to have certain characteristics.

First, they would have to strengthen and encourage the Federal Reserve's natural tendencies to put the achievement of longrun price stability at the top of its list of priorities.

Second, they would need to maintain, if not buttress, the ability of the Fed to allow a course of policy that may be unpopular with the administration.

And, third, they would need to require decisionmakers in the fiscal and budgetary arena to confront more forthrightly the potential longrun consequences of their actions on economic performance.

I do not know of any coordination mechanisms likely to lead to those results. Our best hope of avoiding serious economic policy mistakes, it seems to me, lies in the use of good judgment, common sense, and the political courage to follow an appropriate course of policy.

Your letter of invitation inquires as to whether the increasing openness of the U.S. economy makes existing policymaking mechanisms inadequate or insufficient. I would certainly agree that the increasing openness of our borders to trade and capital flow make the policymaking process more complex.

When economic policies in our country have large cross-border effects, as they do, it is important for economic policymakers to be acutely aware of that. International meetings of economic policymakers can help to foster that objective.

There is certainly room to hope, also, that informal exchanges of views on developments in the major industrial economies of the world may alert policy officials in those countries to developing problems of worldwide inflation, or trade imbalances or other prob-

lems that need addressing. Coordinated intervention in exchange markets by central banks and finance ministries can also be helpful at times.

I don't believe, however, that more formal coordination of domestic economic policies among major industrial countries of the world is likely to be very successful, because sovereign nations do not like to relinquish their monetary and fiscal autonomy.

In the more open economy we now live in, large countries must be increasingly careful to avoid large policy mistakes, mistakes of policy direction and mix, that have impacts far beyond their own borders. Monetary policies in all major countries should make a firm commitment to hold down inflation. This is particularly important in the United States because of the enormity of the liquid financial claims of nonresidents on the U.S. economy. If serious questions were to arise abroad about the willingness of the United States to maintain reasonable stability in the value of its currency, the resulting efforts to withdraw funds invested in our country could have very adverse effects on U.S. economic performance.

That completes my statement, Mr. Chairman. Thank you.

Representative HAMILTON. Thank you very much, Mr. Gramley.

[The prepared statement of Mr. Gramley follows:]

PREPARED STATEMENT OF LYLE E. GRAMLEY

Mr. Chairman and members of the Committee, my name is Lyle E. Gramley; I am a Senior Staff Vice President and the Chief Economist of the Mortgage Bankers Association. I am happy to have this opportunity to give you my thoughts on the economic policy-making process.

I spent a large part of my professional career in the Federal Reserve System, both as a staff member and as a Member of the Board of Governors. I was also a member of the Council of Economic Advisers during the Carter Administration. Given this background, perhaps I can be most helpful to the Committee's deliberations by focussing my testimony principally on monetary policy decisions, how they relate to fiscal policy decisions, and how they affect the achievement of the nation's broad economic objectives.

To summarize my views at the outset, I do not see any major deficiencies in present procedures for making monetary policy, or for coordinating fiscal and monetary policies. I will argue, also, that reducing the independence of the Federal Reserve by putting the Secretary of the Treasury on the Federal Open Market Committee, as H.R. 2795 provides for, would do a good deal of harm.

I certainly would agree that there is room for improvement in economic policy making. As I look back over the past 25 years, several major macro-economic policy mistakes stand out prominently.

They include the inflationary financing of the Vietnam war, the abortive effort to bring down inflation with mandatory wage-price controls in the early 1970s, the excessively stimulative monetary and fiscal policies of the 1970s, which generated double-digit inflation, and finally the enormous Federal budget deficits of the first half of the current decade. I know of no reason to think that any of those policy errors stemmed from deficiencies in policy procedures. Rather, they stemmed purely and simply from bad policy judgments.

Let me begin by talking briefly about the ultimate objectives of monetary policy. We all know that money and prices are related to one another, much more closely in the long run than in the short run. Indeed, most economists would agree that, in the long run, what happens to the stock of money determines principally the level of prices and the rate of inflation, and not the level or growth rate of real output. The converse of that proposition is equally valid--namely, that in the long run, the principal determinant of the level of prices and the rate of inflation is the growth of the stock of money. Economists will disagree as to whether the long run is closer to 2 years or to 20, and whether principally means 80 percent or 90, but setting aside those differences, the general proposition would command widespread agreement.

Let me relate this theoretical proposition to reality with a concrete example. Between the early 1960s and the late 1970s, the U.S. economy went from price stability to double-digit inflation.

There were many contributing factors to the wage-price spiral--such as the way in which the Vietnam war was financed, the suppression of actual inflation by mandatory wage-price controls during a period when monetary and fiscal policies were both highly stimulative, and the two oil-price shocks of 1973 and 1979. However, none of those factors, either alone or in combination, would have led to double-digit inflation if monetary policy had not been accommodative. The Federal Reserve tacitly acquiesced to higher inflation by permitting an excessively rapid growth of money and credit. The Federal Reserve put an end to the inflationary process by adopting tough anti-inflation policies between 1979 and 1982. Had that been done much earlier, double-digit inflation would have been avoided, and the wrenching of the economy needed to bring inflation down during the 1980s would have been less severe also.

If monetary policy largely affects the level of prices, and only the level of prices, over the long run, then it would seem to make sense for the long-run objective of monetary policy to be the achievement of reasonable price stability. That, I believe, is the Federal Reserve's present understanding of its principal role in economic stabilization policy. To be sure, Federal Reserve officials, no less than members of Congress, would very much like to see an increase in our national saving rate, a decline in real interest rates, a higher proportion of the nation's resources devoted to capital formation, a higher growth rate of productivity and potential GNP, and a real value of the dollar in exchange markets that leads to

reduced merchandise trade and current account deficits. These variables, however, are largely beyond the influence of monetary policy over the long run.

By contrast, fiscal policies can have substantial long-run effects on these variables. The mix of government expenditures, the balance between expenditures and revenues, and the kinds of taxes used to raise revenues affect importantly the proportion of national income saved or consumed, incentives to work or save, the level of real interest rates, the rate of capital formation, the real exchange rate and through that route the size of the merchandise trade and current account deficits. If economic performance in these respects is unsatisfactory over extended time periods, Federal fiscal and budgetary policies may be able to help. It is unlikely that monetary policy will be able to make a positive contribution other than that of maintaining reasonable price stability.

I recognize fully that monetary policy in the short run has significant effects on real output and employment, effects that should be taken into account carefully in the conduct of monetary policy. There is a role for monetary policy to play in keeping the economy from getting too far off the track of a path of economic growth consistent with reasonably high output and reasonably stable prices. Troubles arise when the monetary authorities push their knowledge beyond its practical limits, or when they minimize the impact that efforts to squeeze too much output from the economy will ultimately

have on prices. If the monetary authorities are encouraged to take the short-run view, and downplay the long-run consequences, by pressure from the Administration or the Congress, higher inflation is likely to be the result.

Let me call your attention, particularly, to the fact that once inflation has gone on long enough to become deeply imbedded in economic decision-making in the private sector of the economy, no nation as far as I am aware has found a painless way to regain price stability. It is therefore extremely important that monetary policy move quickly to combat budding inflationary pressures before they begin to spread through the economy.

These considerations lead me to be a strong supporter of maintaining the independence of the Federal Reserve from the administrative branch of the government. The Fed often has to make decisions that are politically not very appealing. Independence permits the Fed to make tough decisions, knowing that the long-run benefits of stable prices will more than compensate for the short-run pain of achieving them. Any serious infringement of the Fed's ability to conduct monetary policy on a day-to-day basis would, in my judgement, be a serious loss.

Putting the Secretary of the Treasury on the FOMC, a step contemplated by H.R. 2795, would in my view be a mistake. Such a step would put the Administration in the thick of monetary policy

decisions, and would politicize virtually every such decision the Fed makes. We have a pretty good idea, moreover, in which direction the Administration would be pushing the bulk of the time.

For example, within the past month, the Administration has been carping publicly that the Fed has been running a monetary policy that is too tight, giving too much attention to fighting inflation and not enough to maintaining adequate growth. This criticism comes after an extraordinarily successful monetary policy during the past couple of years. The Fed adroitly tightened its monetary policies in 1988 to nip a flowering inflation in the bud; it then loosened its monetary policies soon enough in 1989 to provide reasonable assurance that the slower pace of economic growth underway this year will not lead to recession. Stopping an inflation without creating a recession is virtually unprecedented in the monetary history of the United States, but it was not good enough for the current Administration.

It is true that putting an Administration official on the Federal Open Market Committee would force the Administration to take more responsibility for the course of monetary policy, but would produce a better monetary policy? If the pressure of the Secretary of the Treasury on the FOMC caused the Federal Reserve to focus more on the short-run effects of its policies, and less on the long-run impact, the likely outcome over the long run would be higher inflation.

Independence from the administrative branch of government does not mean that the Fed should have the freedom to do whatever it pleases in the conduct of monetary policy. In a democratic society, people ought to be able to choose, ultimately, what kind of monetary policy they want, however bad or good that might be. That means that the Federal Reserve ought to be under the control of the Congress, as it is, and that it should report to the Congress regularly, as it does, on what it has done in the past and what it plans for the future. Reporting requirements were increased considerably in the early 1970s and were formalized in 1978 when the Humphrey-Hawkins Act became law. As you know, Chairman Greenspan appears before the Congress frequently to report on the Fed's stewardship in the conduct of its monetary policy responsibilities.

Let me turn now to some comments on coordination of monetary and fiscal policy. As you know, the reporting requirements of the Humphrey-Hawkins law are the principal mechanism for ensuring that monetary and fiscal policies work together harmoniously. Informal mechanisms for sharing of information abound, and they permit a full exchange of information--at least they did when I was a Member of the CEA and a Member of the Federal Reserve Board. Would additional formal mechanisms for coordination of economic policies help to provide a better economic policy environment? Past experience does not provide much support for this view.

There are two cases during the past 25 years in which a deliberate effort was made by the Federal Reserve and the Administration to work out a more satisfactory mix of policies. The first was in 1968, when the Federal Reserve was trying to restrain inflation while fiscal policy was overly expansive. Chairman William McChesney Martin sought to persuade President Johnson that a tax increase was essential to finance the Vietnam war; he indicated that monetary policy would ease if fiscal policy were tightened. In the summer of 1968, President Johnson imposed a one-year surcharge on individual and corporate income taxes. Having given his promise, Chairman Martin eased monetary policy by lowering the discount rate and bringing down market interest rates. Since the income tax surcharge was temporary, however, it had little effect on private aggregate demand. The result of the changed policy mix, consequently, was the worst of all possible worlds--fiscal policy did not become meaningfully tighter, and monetary policy became easier.

Another abortive attempt occurred early in 1980. In October 1979, the Federal Reserve launched a new and vigorous effort to bring down inflation by limiting growth of money and credit. Interest rates soared. The Carter Administration was none too happy about the sharp jump in interest rates, and reasoned that perhaps credit growth could be restrained with less pressure on interest rates if credit controls were invoked. The Carter Administration therefore gave the Fed the authority to impose credit controls under the Credit Control Act of 1969. The Federal Reserve

24-378 O - 90 - 2

was not very enthusiastic about the idea, but felt it could not ignore the President's wishes in this matter. Working with economists in the Carter Administration, the Federal Reserve put together a set of credit controls that had far harsher effects on aggregate demand-- especially consumer spending-- than anyone had anticipated. The credit control program was a major contributor to the sharp but short recession of 1980, and it was dismantled by the Federal Reserve at the earliest opportunity.

Coordination of monetary and fiscal policies is not an end in itself, but a means to a better economic performance by reducing the frequency and severity of economic policy mistakes. If my understanding of how monetary and fiscal policies work is correct, mechanisms of coordination to accomplish that objective would need to have certain characteristics.

(1) First, they would have to strengthen and encourage the Federal Reserve's natural tendencies to put the achievement of long-run price stability at the top of its list of priorities.

(2) Second, they would need to maintain, if not buttress, the ability of the Federal Reserve to follow a course of policy that may be unpopular with the Administration.

(3) Third, they would need to require decision-makers in the

fiscal and budgetary arena to confront more forthrightly the potential long-run consequences of their actions on economic performance.

I do not know of any coordination mechanisms likely to lead to those results. Neither do I believe that legislated rules of behavior--such as providing for a constant growth rate of money balances, or a balanced Federal budget -- are likely to be beneficial. Our best hope of avoiding serious economic policy mistakes lies in the use of good judgement, common sense, and the political courage to follow an appropriate course of policy.

Your letter of invitation inquires as to whether the increasing openness of the U.S. economy makes existing policy-making mechanisms inadequate or insufficient. I would certainly agree that increasing openness of our borders to trade and capital flows makes the policy-making process more complex. For example, it increases the exposure of the U.S. economy to shocks coming through changes in the exchange rate, which can have large and powerful effects on U.S. manufacturing. Furthermore, since monetary policy now works in the short run by affecting exchange rates, there is a new channel of influence on the economy that is less well understood than the traditional ones. It is often said that we are no longer the masters of our own destiny. We need to remember also that the welfare of individuals in other countries is profoundly influenced by economic policy decisions made in the U.S.

When economic policies in our country have large cross-border effects, as they do, it is important for economic policy makers to be acutely aware of that fact. International meetings of economic policy makers can help to foster that objective.

There certainly is room to hope, also, that informal exchanges of views on developments in the major industrial economies of the world may alert policy officials in these countries to developing problems of world-wide inflation, or trade imbalances or other problems that need addressing. Coordinated intervention in exchange markets by central banks and finance ministries can also be helpful at times when exchange rate relationships among their currencies are out of touch with the fundamental determinants of equilibrium relationships. I do not believe, however, that more formal coordination of domestic economic policies among major industrial countries of the world is likely to be very successful, because sovereign nations do not like to relinquish their monetary and fiscal autonomy.

In the more open economy we now live in, large countries must be increasingly careful to avoid large policy mistakes -- mistakes of policy direction and mix -- that have impacts far beyond their own borders. Such mistakes in the U.S. may generate reactions abroad that affect profoundly the ability of the U.S. to achieve its broad economic policy objectives. Monetary policies in all major countries

should make a firm commitment to holding down inflation. This is particularly important in the U.S. because of the enormity of the liquid financial claims of nonresidents on the U.S. economy. If serious questions were to arise abroad about the willingness of the U.S. to maintain reasonable stability in the value of its currency, the resulting efforts to withdraw funds invested in our country could have very adverse effects on U.S. economic performance.

The new openness of our economy is also putting strains on the ability of existing statistical programs to keep track of what is happening, and to permit in-depth analysis of the forces affecting the economy. I was privileged to be a member of a Committee on Economic Statistics sponsored by the American Economic Association which studied the inadequacies of the existing statistical system and made broad recommendations for change. That report was shared with the staff of the Joint Economic Committee about a year ago. I would urge the JEC to support added funding for the major statistical agencies of the Federal Government to enhance their ability to track economic developments more adequately.

Representative HAMILTON. Ms. Rivlin, please proceed.

STATEMENT OF ALICE M. RIVLIN, SENIOR FELLOW, THE BROOKINGS INSTITUTION, AND FIRST DIRECTOR, CONGRESSIONAL BUDGET OFFICE

Ms. RIVLIN. Thank you, Mr. Chairman.

I am delighted to be appearing again before the Joint Economic Committee. I am also pleased that you are turning your attention to the economic policymaking process and how it could be improved. It's a subject that deserves some thoughtful and imaginative attention.

Let me begin, however, with a word of caution: Making economic policy is inherently difficult, and it is not likely to get easier. It's always tempting to hope that some new way of organizing the policymaking process—restructuring executive branch agencies or congressional committees, or forging new links between the White House and the Congress or the Treasury and the Federal Reserve, for example—will make the choices less agonizing.

Unfortunately, I believe the contribution that procedural reform can make is pretty limited. The main reason that economic policymaking is so difficult, of course, is that it always involves balancing the interests of different individuals and groups—producers and consumers, rich and poor and middle, young and old and yet unborn.

The second reason is that economic decisions are normally made under great uncertainty. The economic system is extremely complex. Economists do not have a definitive blueprint of exactly how it works, and it doesn't hold still while we find out. Hence, predictions about the course of the economy and the effects of policies are never highly reliable.

Neither source of difficulty seems likely to diminish in the future. One might think that over time, as countries get more affluent, these choices will get easier. I doubt it. Poor countries, like poor families, have very few options. Rich countries, like rich families, have more options and greater access to credit, which means they have much more difficult choices to make between the present and the future.

One might also hope that the uncertainty surrounding policy decisions would decline as economists learn more about how the economy works, but unfortunately this increasing knowledge is likely to be overwhelmed by other developments.

As the world economy becomes increasingly complex and interrelated, and as communications and worldwide transfers of funds become instantaneous, the degree of uncertainty surrounding the policy decisions of individual governments seems likely to escalate.

If it can't make economic policymaking easy, what can an effective set of economic policymaking institutions and procedures be expected to do? I think four things:

One is clarify choices. Make as clear as possible to decisionmakers and to the public what is being decided and what is known and not known.

Second is enhanced discipline. Make it as likely as possible that decisions are actually faced and made.

Third is to encourage thinking ahead to counteract the shortrun bias of politics.

And fourth is to minimize the cost of deciding. Keep the time and resources devoted to choosing policies within reasonable limits, so that energy is left over for carrying them out. There are trade-offs among these objectives of course, but at present U.S. economic policy processes leave much to be desired on all four counts.

Responsibility for economic policy, international as well as domestic, is extraordinarily diffused and fragmented both in the Congress and in the executive branch. The process of arriving at decisions is complex, multilayered, and often seemingly endless. The budget process is a notorious, but by no means unique, example.

The large number of steps and stages, committees and agencies, involved in putting together the annual budget for the U.S. Government makes the budget-making process extremely lengthy, arduous, costly and, above all, confusing. Even the participants have great difficulty understanding what is going on. The press loses patience, and the public ends up without any clear idea of what is at stake or what has been decided.

I think that is perhaps the most important point, that is, in getting increasingly arcane procedures, which seemed like good ideas at the time, we have lost the public. The public doesn't know what the Congress and its government are doing.

The budget process should be simplified, and the number of stages and institutions involved should be reduced. In the Congress I believe this must mean reducing the number of committees. I have made one proposal under which the authorizing and appropriating committees would be combined into a set of "program" committees, one for each set of major spending programs, such as defense or social insurance.

Other blueprints for consolidation have been suggested by others, including a joint committee on the budget, but some way must ultimately be found to reduce the complexity inherent in the triple layering of authorizing, appropriating, and budgeting committees in both Houses of Congress.

An even more serious failing of current economic policy deliberations is their almost complete absorption with the near term. Again, the budget process is a good example, but only one of many. The Gramm-Rudman-Hollings law was a desperate attempt to impose external discipline on the budget process and force decisions that would reduce the budget deficit.

It has had some positive impacts, but also considerable costs, and I think these are the costs that attach to any focus on a single year's outcome.

One cost has been the escalation in the amount of budget gimmickry, ranging from use of overoptimistic forecasts to pure phoniness, such as moving pay dates back into the previous fiscal year.

Another costly effect has been to reduce concern with the future and concentrate almost exclusive attention on shortrun efforts to meet—to appear to meet—the deficit target for the upcoming fiscal year.

America is facing new economic challenges in the next decade and beyond for which we must be preparing now. The age structure of the population and the composition of the labor force will

change dramatically over the next few years. If we are to achieve a rising standard of living and compete successfully in world markets, we need to increase saving and investment, improve the productivity of the labor force and increase the flexibility and adaptability of the economy. These decisions will not get made by a policy process that focuses so heavily on the next fiscal year.

The shift to a longer planning period must occur on many fronts. A biennial budget would be a small step in the right direction, I think a very small step, but a useful one. Its main virtue would be in freeing both the Congress and the executive branch from the heavy burden in making a budget every year. It would allow both the Executive and the Congress, if they chose to do so, to concentrate on better implementation of decisions and on planning for a longer period.

Serious 5- to 10-year options for many aspects of economic policy should be developed and debated and steps taken in the near to move in desired directions. If we do not start thinking seriously about the economic needs of the future, we will find the future catching us unawares.

Mr. Chairman, this concludes my brief statement. I have spoken at somewhat greater length on this general subject in an address to the American Economic Association, which I would be happy to have the committee include in its record, if you so desire, and I would of course be happy to answer questions.

Thank you.

Representative HAMILTON. Without objection, the address to the American Economic Association will be made part of the record.

[The address to the American Economic Association follows:]

Economics and the Political Process[†]

By ALICE M. RIVLIN*

I want to use this once-in-a-lifetime opportunity for pontificating to the profession, to explore ways of improving the interaction between what economists do and the political process. Tension and conflict are, of course, inherent in political decisions, especially on economic policy. Nothing can make such decisions easy. Nevertheless, it is my contention that economic policymaking in Washington in the last decade has been more frustrating, muddled, and confusing than necessary. Some of the fault lies with economists and economics; some with politicians and the political process; some in the interactions. I want to offer some suggestions for modest improvements.

Most economists probably share my premise that economics ultimately ought to be more than just challenging intellectual gymnastics. It ought to help us understand how the economy works and provide a basis for intelligent political choices among economic policies. Even those who devote their energies to resolving purely theoretical issues imagine that somehow in the end their efforts will prove socially useful.

The dedicated, idealistic young economist who aspires to advise a government may well envision herself someday as the wise and impartial adviser to the philosopher queen. In this daydream, the adviser presents the best forecasts that can be made of the future course of the economy. She explains the macroeconomic policy options and what is likely to happen if each is undertaken. She elucidates why market solutions are efficient, when markets are likely to fail, and what can be done when this occurs. She identifies risks and uncertainties, which fortunately are not overwhelming. She represents the best professional judgment of her fellow economists, indicating the major respects in which most economists agree and scrupulously pointing out that in minor respects the views of some of her professional colleagues might differ from her own. She remains above the political fray, identifying any values or distributional biases that may creep into her judgments and eschewing identification with interest groups or ideological causes.

The queen for her part listens carefully and intelligently, asks thoughtful questions, and weighs the options. She may consult other experts on noneconomic aspects of the decisions, but these can be assumed not to be very important. She then makes final decisions—even very hard ones—and sticks to them. The decisions are carried out, the economy prospers, and a grateful nation applauds the wisdom of the monarch and her economist and the usefulness of economics.

But in the real world, both economics and politics are frustratingly unlike this picture. Both are pluralistic in the extreme and appear to be getting more so. Economists and political leaders not only miscommunicate, but each accuses the other of incompetence, obfuscation, self-serving motives, and antisocial behavior.

Economists, of course, do not wait for others to attack them; they do it themselves. Walter Heller said in his presidential address that the "chorus of self criticism has risen to a new crescendo" (1975, p. 1), and the self-deprecation has not abated in the intervening decade. If a golden age of economists' self-confidence ever occurred, it is long past. Events of recent years have kept reminding us that our national economy is diverse and complex, battered by unpredictable shocks, and increasingly interconnected with the even

*The Brookings Institution, 1775 Massachusetts Avenue, N.W., Washington, D.C. 20036. The views set forth here are solely my own and do not necessarily represent the opinions of the trustees, officers, or other staff members of the Brookings Institution. I am grateful for the insights and assistance of many colleagues, especially Robert D. Reischauer, Charles L. Schultze, Mary S. Skinner, and Valerie M. Owens.

[†]Presidential address delivered at the ninety-ninth meeting of the American Economic Association, December 29, 1986, New Orleans, Louisiana.

more diverse and complex world outside our borders. Knowledge of how the domestic economy works and interacts with the rest of the world is imperfect. Economists keep coming up with ingeneous theories, but they have a hard time testing them. Data are inadequate and controlled experimentation nearly impossible. Modeling has greatly enhanced our understanding of the past, but shows few visible signs of improving the reliability of macroeconomic prediction. Forecasting even for short periods remains an uncertain art in which neither economists nor politicians can have much confidence.

Many of the most sophisticated and realistic members of the profession, conscious of all these difficulties, have abandoned the attempt to advise governments on policies in favor of the more manageable tasks of adding to the knowledge base. This may be understandable, but it deprives the economic policy debate of the input of some very good minds and runs the risk of leaving the job of interacting with the political arena disproportionately to those with strong ideological views.

I. Fragmentation of the Economic Policy Process

The pluralism of economics pales beside the pluralism of the political system that policy-minded economists aspire to assist. Even if one leaves aside the complexities of federalism, the process by which national economic policy evolves in Washington is so fragmented and complicated that it is almost impossible to explain to the uninitiated how it is supposed to work, let along how it does work.

A well-founded distrust of despots led our forefathers not only to opt for representative democracy, but to divide power among the executive and legislative and judicial branches, and between the House and the Senate. On matters of taxing and spending, they were especially protective of the power of the people's representatives, making it clear that while the president could propose taxing and spending, the ultimate authority lies with the Congress, subject only to presidential veto. This divided power creates a built-in hurdle to making and carrying out fiscal policy. The hurdle is low when the president is articulating a policy that has broad support in the country and in the Congress. It can lead to erratic shifts of policy when the president is indecisive, and to deadlock when the president is leading in a direction in which the public and its elected representatives do not wish to go. Deadlocks are rare, but can be serious. The failure to reduce the huge structural budget deficit of the mid-1980's largely reflects the fact that the president's solution—drastic reduction of the federal role in the domestic economy—does not command broad popular support.

The separation of powers between the Congress and the president is basic to our system of government and probably worth the price of occasional deadlock. The difficulties of making economic policy, however, are strongly compounded by the propensity of our pluralistic society to diffuse power and decision-making authority both within the executive branch and within Congress. With respect to taxing and spending policy, for example, the simple notion that the president proposes and the Congress disposes is greatly complicated by the fragmentation of power within each branch. Moreover, periodic efforts to make the policy process more coherent within each branch, while often temporarily successful, have added new power centers without consolidating the old ones.

In the executive branch, the trend since early in the century has been to centralize power in the White House in order to make it easier for the president to formulate and articulate taxing and spending policy, and to utilize the growing skills of the economics profession to that end. But this worthy goal has been accomplished in stages, with a new institution added at each stage. The creation of what is now called the Office of Management of Budget (OMB) in the 1920's made it possible for the president to review and evaluate spending requests and impose a set of priorities on his budget proposal to Congress reflecting his administration's view of the appropriate size and role of government. The creation of the Council of Economic Advisers (CEA) in the 1940's provided a

focal point for bringing the advice of the economics profession into the service of presidential decision making and a locus for creating an official forecast of economic activity.

The creation of OMB and CEA improved the president's ability to formulate and articulate macroeconomic policy. It also left the president, in addition to his other impossible duties, with the job of resolving a built-in tension over responsibility for economic policy among the CEA, OMB, and the Treasury, not to mention the White House staff and the agencies with line responsibility for implementing various aspects of economic policy.

Presidents have tried various coordination mechanisms including "troika" arrangements and an almost infinite variety of broader councils and committees with varying membership, responsibilities, and leadership. The system works tolerably well or exceedingly creakily, depending on the president's personal style and the personalities involved. But it encourages battling over turf as well as substance, and is hardly designed to minimize the amount of presidential energy needed to evolve a coherent, explainable policy on taxing and spending. One might wonder whether it is not time to do what so many other countries do and give our president the equivalent of a responsible finance minister charged with the functions now diffused to our budget director, Council of Economic Advisers, and Treasury Secretary.

The fragmentation of power and responsibility is, of course, even more extreme in the Congress. The legislative branch also has a long history of attempts to make taxing and spending policy in a more coherent fashion by adding new coordinating institutions—appropriations committees, a joint economic committee, budget committees, a congressional budget office—without eliminating or consolidating any of the old ones.

The most recent attempt to improve congressional economic decision making—one in which I was an active participant—followed the Budget Reform Act of 1974 which created the budget committees and the Congressional Budget Office. These budget reforms succeeded in their main objective of focusing the attention of the Congress on overall budget policy, not just individual taxing and spending fragments. They have forced the Congress to fit the pieces together, to debate and vote on an overall taxing and spending plan—a budget resolution—to which specific taxing and spending matters must conform. No one can say that the Congress in the last few years has ignored fiscal policy! The creation of the Congressional Budget Office, moreover, has given Congress independent access to forecasts, projections, and analysis of economic options.

The downside of the budget reforms, however, was that the budget process was superimposed on the already complex responsibilities of authorizing, appropriating, and tax committees. It has added to the layers and stages of congressional policymaking without removing any of them, has made the process of budget decision making nearly impossible even for members of Congress to understand, and increased the workload so much that decisions are routinely made late and in an atmosphere of crisis. Moreover, Congress now frequently has to deal with two sets of estimates, those of the OMB and those of the Congressional Budget Office, which may differ because they are based on different forecasts of economic activity, or for even less obvious technical reasons.

Meanwhile, back in the separate world of the Federal Reserve, monetary policy is being decided and carried out. It is a curious paradox that a nation, which feels it needs many more hands on the tiller of fiscal policy than most countries regard as workable, is content to leave monetary policy to a central bank with fewer visible ties to the rest of the government than the central banks of most countries.

There is plenty of informal communication, of course, especially between the Federal Reserve and the hydraheaded economic establishment of the executive branch. More formal cooperation between the monetary and fiscal authorities, as in the United Kingdom, might contribute only marginally to making monetary and fiscal policy decisions part of a more coherent strategy for

the economy—and at the cost of depriving the executive branch of the luxury of blaming the Federal Reserve when things go wrong. The love-hate relation between the Congress and Federal Reserve, however, warrants more attention. Despite occasional outbursts of anxiety over escalating interest rates, Congress has shown little inclination to control monetary policy, or even to inquire into the consistency of monetary and fiscal objectives. The Fed is required to report monetary growth targets to the banking committees, as though monetary policy were a matter of banking system regulation, but has little genuine interaction with the budget committees whose job is to debate and propose fiscal policy.

II. The Process under Stress

This whole complicated economic policy system has been subjected to enormous strain in recent years. Political economists like to harken back to the golden years of the 1950's and 1960's when economists got respect and the economic policy machinery functioned smoothly. The nostalgia is only partly a result of faulty memories. It's not hard to be satisfied with economists and policy processes when the economy is growing, productivity marches steadily upward, and even the national debt is obligingly declining in relative importance. It's much harder when productivity growth plummets for reasons that no one honestly purports fully to understand, expectations of public and private consumers have to be cut back to fit with slower income growth, and inflation and interest rates are bouncing around at unfamiliar levels.

Adjusting to the energy shocks and slower growth that began in the 1970's strained the economic policy processes of all industrial countries and made the participants feel frustrated and inadequate. It's not obvious, even with hindsight, that the fundamental difficulties facing the industrial world in the 1970's can credibly be blamed on economists or any particular structure of government or economic policy responses, but all came in for their share of the understandable hostility.

The difficulties of the U.S. economy in the 1980's, by contrast, revolve heavily around an economic policy mistake: the creation of a large structural deficit in the federal budget. I do not believe that the structure of our economic decision process was the cause of the mistake. Blaming the deficit on inherent flaws in the policy process requires an explanation of why the process did not cause similar mistakes in the past. But the events of 1981 which produced the deficit illustrate several of the difficulties of economic policymaking which make mistakes harder to avoid:

the uncertainty of macroeconomic forecasting;

the isolation of monetary and fiscal policy;

the contentiousness of economists and their tendency to let their ideological positions cloud their judgments about the likely effects of particular policies.

That a tax cut unmatched by comparable spending cuts would produce a deficit should have surprised no economist. That the deficit was so large reflected both economic and political miscalculations. The Reagan Administration has been faulted for masking the deficit with a "rosy scenario," but the fact is that most of the forecasting community, including the Congressional Budget Office, expected positive real growth in the economy. The administration's official forecast differed from the rest only in its degree of optimism. Forecasters in and out of government were oversanguine about growth largely because they failed to realize how serious the Federal Reserve was about reining in the money supply to control inflation. The Fed was not defying the administration, which was touting the efficacy of monetary stringency for controlling inflation, but hardly anyone seemed to remember that the way tight money controls inflation is by slowing economic activity. Moreover, as our Association's President-elect, Robert Eisner, has pointed out (1986, p. 146), the economics community, unfamiliar with a world of high inflation rates, overestimated the stimulative effect of the existing deficit. Added to this was the enthusiasm of the ideological proponents of smaller government, some of whom

exaggerated the possible effects of lower tax rates on supply and some of whom simply hoped that deficits would pressure Congress to cut back domestic spending. The size of the deficits was also masked by the assumption of unspecified future spending cuts, an assumption reflecting the view that the U.S. government was operating a lot of wasteful programs with little public support which Congress could soon be persuaded to reduce or eliminate.

Both in the administration and in Congress, decisions were made at a breakneck pace, in a highly charged political atmosphere, amid conflicting claims and competing forecasts, with little attention to the consistency of monetary and fiscal policy and mostly by people with little experience in evaluating the reasonableness of any set of economic estimates. (See David Stockman, 1986, ch. 3.) When the dust settled, we found ourselves with a serious recession that nobody expected, and an escalating structural budget deficit that nobody wanted. It was hardly economic policy's finest hour.

The agonizing—and so far only partially successful—struggle to correct the mistakes of 1981 have kept the economic policy process under stress and have continued to dramatize some of its weakest aspects. The struggle between the president and the Congress over deficit solutions illustrates the price we pay for the separation of powers. The fact that fiscal policy has become an exercise in damage control, while the Federal Reserve makes all the important decisions about the economy, underlines the separation of monetary and fiscal policy. The sensitivity of deficits to the pace of the economy advertises the unreliability of macroeconomic forecasts. The fact that all the actions that could be taken to correct the deficit are unpleasant ones drags out the annual agony of budget setting interminably and dramatizes how layered and cumbersome it has become.

Small wonder that the strains of the last few years, with a little help from the press, have reinforced the negative stereotypes that economists and political decision makers have of each other. Political decision makers see economists as quarrelsome folks who cannot forecast, cannot agree, cannot express themselves clearly, and have strong ideological biases. Economists return the favor by regarding politicians as shortsighted, interested only in what is popular with the electorate, and unwilling to face hard decisions. All of the stereotypes are partly right.

Politicians embody their stereotype in economist jokes. Economists have retaliated more massively by applying the tools of their trade to the political system itself. Public choice theory essentially asks the question: what would economic policy be like if our stereotype of politicians were entirely true? The answer provides considerable insight into observed political behavior and certainly helps explain why the idealistic economist so often fails to find the system simulating the public interest motivation of the philosopher queen.

III. Some Drastic Nonsolutions

Widespread concern that the economic policy process is not working well has spawned proposals for drastic change that move in two quite different directions: one toward circumscribing the discretion of elected officials by putting economic policy on automatic pilot and the other toward making elected officials more directly responsible to the voters for their policies.

The automatic pilot approach flows from the perspective of public choice theory that the decisions of democratically elected officials interested in staying in office cannot be counted on to produce economic policy in the social interest, but are likely to be biased toward excessive government spending, growing deficits, special interest tax and spending programs, and easier money. A way to overcome these biases is to agree in advance on strict rules of economic policy, such as a fixed monetary growth path or constitutionally required balance in the federal budget.

Even if one accepts the premises, however, firm rules are hard to define in a rapidly changing world—no one seems to know what "money" is anymore—and can easily lead to perverse results. Recent experience with

trying to reduce the federal deficit along the fixed path specified by the Gramm-Rudman-Hollings amendment, for example, has given us a taste of some of the possible disadvantages of a balanced budget rule. There is danger that specific dollar targets for the deficit will require procyclical fiscal policy, perhaps precipitating a recession that would then make budget balance even less attainable. Moreover, the effort to reach the targets can induce cosmetic or self-defeating measures, such as moving spending from one fiscal year to another for no valid reason, selling assets to reduce a current deficit while exacerbating future ones, and accomplishing desired purposes by regulatory or other nonbudgetary means.

The Gramm-Rudman-Hollings experience, however, has suggested the usefulness of a different approach to deficit reduction than a balanced budget rule; namely, a deficit neutral amendment rule. If legislators advocating a tax preference are required to propose a rate increase to pay for it, special interest tax legislation may falter. Similarly, the requirement that a proposal for additional spending be accompanied by a simultaneous proposal to raise taxes or reduce another spending program may be an effective brake on deficits.

The other direction of reform reflects the contrasting view that the separation of powers and the diffusion of responsibility in our government make it too difficult for the electorate to enforce its will by holding officials responsible for their policies. The potential for deadlock would be reduced if the United States moved toward a parliamentary system, or found a way to hold political parties more strictly accountable for proposing or carrying out identifiable policies.

Casual examination of parliamentary democracies, such as the Untied Kingdom and Sweden, does not provide striking evidence of the superiority of parliamentary systems for making economic choices, even if one did not have two hundred years of tradition to contend with in changing our system. The more modest notion that our system would work more smoothly if political parties had better defined positions and disciplined their elected members more strictly may well be right, but seems to fly in the face of current history. Voters are showing less strong party affiliation and more inclination to choose for themselves among candidates, while members of Congress tend increasingly to be pragmatists willing to work out nonideological compromises across party lines. These trends seem likely to be the irreversible consequences of greater education, sophistication, and exposure to public issues among voters and elected officials alike and to make a resurgence of party discipline and loyalty unrealistic.

IV. Making the Economic Policy System Work Better

My own proposals involve less drastic changes in the structure of our government. They reflect a strong faith in the ability of informed citizens and their elected representatives to make policy decisions for the common good, even to make substantial sacrifices and take political risks to further what they perceive as the long-run national interest—once they understand what the choices are. I also believe that the separation of powers between the executive and legislative branches works pretty well most of the time. It provides needed protection against overzealousness in either branch, albeit at some risk of occasional stalemate.

The main problem, it seems to me, is that our economic policy system has gradually become so complex, diffused, and fragmented that it impedes rather than fosters informed choices on major issues. The fragmentation imposes two kinds of costs. First, it makes the decision process itself exceedingly inefficient. Decisions are made too often, in too great detail, and reviewed by too many layers of decision makers in the executive branch and in Congress. Too much time is absorbed in procedure and in wrangling over details, not enough on major decisions. It's time to simplify the process, to weed out some of the institutions, and to tip the balance between substance and process back toward substance.

Second, decisions are made separately that ought to be made together, or at least with

attention to their impact on each other. The separation of monetary and fiscal policy is one example; the separation of tax and spending decisions is another. Congress has made a good deal of progress in recent years in putting spending decisions together with their revenue or deficit consequences, but more could be done. I have seven steps to suggest that might make the economic policy process work more effectively.

First, seek out decisions that should be made less frequently and arrange to do so. This would economize decision-making time and enhance the chances of thoughtful, well-informed decisions. It would free up time and energy for managing the government enterprise more effectively, with a longer planning horizon. It would also reduce the inefficiency and sense of unfairness that goes with frequent changes of the rules. Making the federal budget every other year would be a major advance. Major revisions of the tax code should occur even less frequently. Big ticket acquisitions, such as major weapons systems, should be reviewed thoroughly at infrequent intervals and then put on a steady efficient track, not constantly revisited.

With a two-year budget, there would occasionally be major events, such as a sudden escalation of international tension or a sharp unexpected shift in the economic outlook, that would justify reopening the budget in midstream, but the temptation to tinker frequently should be strongly resisted. The argument that economists cannot forecast accurately two years in advance, while quite true, does not undermine the case for a multiyear budget. It simply reinforces the point that discretionary fiscal policy is hazardous and ought to be viewed with great skepticism whether the budget is annual or biennial.

Second, seek out decisions that need not be made at all and stop making them. Some spending programs could be consolidated into block grants or devolved to the states, not necessarily in the interest of smaller government, but in the interest of greater responsiveness to local needs and a less cluttered federal decision schedule. In other cases, the responsibility is clearly federal—as in defense—but Congress would be doing its job more effectively if it concentrated on major policy issues rather than on details of program management.

Third, in the executive branch, consolidate authority for tax, budget, and fiscal policy in a single cabinet department. The department could retain the name Treasury, but might better be called the Department of Economic Affairs. The Secretary of Economic Affairs should have a high level chief economist or economic council with a strong professional staff. The chief economist should work closely with the budget director who also should report to the Secretary. The purpose would be to bring together economic decisions now made in OMB, CEA, and Treasury under one high-level responsible person, to relieve the president of the duty of adjudicating among so many potentially warring power centers, and to increase the chances of building a highly professional permanent economic staff one step removed from the short-run political concerns of the White House.

Fourth, streamline the congressional committee structure to reduce the number of steps in the budget process. The authorizing and appropriating functions should be combined in a single set of "program committees," one for each major area of public spending. This would imply a single defense committee, for example, and a social insurance committee. The tax committees should handle the revenue side—not additional spending programs as at present. The budget committees would be charged with considering fiscal policy and putting the spending and revenue sides together into a budget to be passed by the whole congress. The Joint Economic Committee should celebrate the important contributions it made to economic understanding in the days before the budget process and then close up shop.

Fifth, bring monetary and fiscal policy into the same conversation. This end could be furthered by closer formal links between the central bank and the Department of Economic Affairs to dramatize the need for consultation and interaction. The Federal Reserve chairman should make a report to the

budget committees of Congress laying out recommended short- and longer-run economic goals for the nation and discussing combinations of monetary and fiscal strategies to achieve them. The Fed's report should be an important input to congressional deliberations on fiscal policy.

Sixth, strive for a government-wide official economic forecast to be updated on a regular schedule. The main purpose of the common forecast would be to reduce the confusion generated by conflicting estimates, but the increased interaction between the Department of Economic Affairs, the Congressional Budget Office, and the Federal Reserve necessary to create such a forecast would increase mutual understanding of what is happening to the economy and what the goals of policy should be. Occasionally, it might be necessary for one of the agencies to dissent and explain why it disagreed with the forecast, but these occasions are likely to be infrequent. There should also be more attention than at present to the consequences for policy of the forecast being wrong.

Finally, bring choices explicitly into the decision process, both in executive branch deliberations and, especially, in Congress. Those proposing spending increases or tax reductions should routinely be required to specify what is to be given up and to offer both the benefit and its cost as a package. In other words, proposals should be deficit neutral.

V. What Economists Can Do

For their part, how can economists be more useful in the policy process? The press and politicians often sound as if they are telling us to work harder: go back to your computers and don't come out until you known how the economy really works and can give us reliable forecasts. But economists know that the economic system is incredibly complicated, and that increasing global interdependence and rapidly changing technologies and public attitudes are not making it easier to understand. It is not likely in our lifetimes that anyone will happen on a paradigm that explains everything, or even that forecasting will become appreciably more accurate. Like the medical profession, which also deals with an incredibly complex system, we economists just have to keep applying our imperfect knowledge as carefully as possible and learning from the results. Both doctors and economists need humility, but neither should abandon their patients to the quacks.

The objective of economists ought to be to raise the level of debate on economic policy, to make clear what they know and do not know, and to increase the chances of policy decisions that make the economy work better. Much of the time that means telling the public and politicians what they would rather not hear: hard choices must be made. We are stuck with being the dismal science.

Increased effort in three directions would make economics more useful in the policy process. First, *economists should put much more emphasis on their areas of agreement.* The press admittedly makes this difficult. Agreement is not news, and the press' stereotype of economists' diversity of views is so entrenched that they will go to great lengths to scare up a lonely dissenter to an almost universally held economic platitude and give her equal time.

Economists realize that the breakthrough insights around which "schools" are built are at best partial visions of the truth, but our training leads us to elaborate and differentiate these insights, to explain to ourselves and to others where they lead in different directions, not where they come together. Yet areas of agreement are wide—even in macroeconomics—and a major effort to make this clearer to ourselves and our audience would be useful.

Second, *economists should devote more serious attention to increasing the basic economic literacy of the public, the media, and the political community.* While the print media seem to me increasingly knowledgeable and sophisticated about economic issues, television, where most people get most of their information, lags far behind. Television coverage of the economy is heavily weighted to isolated economic statistics reported without context—the wholesale price index increased two-tenths of a percent in October—and talking heads disagreeing, briefly, for some obscure reason. Some of the best newscasters appear to have bad cases of economics phobia.

Media bashing is not the answer. The profession needs to take the lead in explaining more clearly what is happening to the economy, why it matters, and what the arguments are about or ought to be about. This means more than each of us taking a little time to make a luncheon speech, write an op ed piece, or appear on a talk show. It means sustained efforts on the part of teams of economists to figure out how to present economic ideas more interestingly and understandably, developing new graphics and other teaching tools and getting feedback from real audiences. The technology is available and the audiences exist—the number of people who will watch long hard-to-follow congressional debates and hearings on cable television is quite astonishing. We just need to devote the kind of effort and ingenuity that goes into explaining to audiences the complex, fast-moving, jargon-ridden game of football to our complex, fast-moving, jargon-ridden game of economics.

Third, *economists need to be more careful to sort out, for ourselves and others, what we really know from our ideological biases.* George Stigler pointed out in his presidential address (1965) that economists beginning with Adam Smith have not hesitated to make strong assertions, both positive and negative, about the effectiveness of government intervention without offering serious evidence to support their claims. For two hundred years, "the chief instrument of empirical demonstration on the economic competence of the state has been the telling anecdote" (pp. 11–12). In the more than two decades since Stigler presided over our Association, an enormous amount of useful empirical work has been done, as he predicted it would be, on the effectiveness of government programs, the costs and benefits of regulation, and so forth. Still the arguments among economists about the merits of larger vs. smaller government too often revolve around anecdotes or, worse, misleading statistics quoted out of context. My own anecdotal evidence would lead me to believe that liberals and conservatives are about equally guilty.

My concern is not with economists taking sides on policy issues or acting as advocates of particular positions. Indeed, I think many policy debates would be clarified if there were more formal and informal opportunities for economists to marshall the evidence on each side and to examine and cross-examine each other in front of some counterpart of judge or jury.

We economists tend to be uncomfortable in the role of partisans or advocates, preferring to be seen as neutral experts whether we are or not. Lawyers move more easily among roles; and the best are able to serve with distinction at different times as prosecutors, defenders, experts, and judges. The system works well when the roles are played competently and the rules of evidence strictly observed. Economists might increase their usefulness to the policy process if they made clear at any given moment which role they were playing. More important, we need to work hard to raise the standards of evidence, to make clear to the public and the participants in the political process what we are reasonably sure we know and how we know it, and where we are guessing or expressing our preferences.

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Representative HAMILTON. Mr. Stein, please proceed.

STATEMENT OF HERBERT STEIN, SENIOR FELLOW, THE AMERICAN ENTERPRISE INSTITUTE, AND FORMER CHAIRMAN, COUNCIL OF ECONOMIC ADVISERS

Mr. STEIN. Thank you.

Mr. Chairman and members, I agree entirely with what my two colleagues have said, and I have been wondering to myself where one would have found an economist who disagreed, but I have a somewhat different emphasis in some points.

There have been many mistakes of economic policy in the experience of all of us present today—say in the past 30 years. It is appropriate that this committee should consider why these mistakes were made and how similar mistakes might be avoided in the future.

To do this we must start with an idea of what the mistakes were. In my opinion, the chief mistakes were these, and I was interested to see how close they are to Mr. Gramley's list of mistakes:

First, a persistent tendency to overly expansive monetary policy, with the result that consumer prices are now 4¼ times as high as they were 30 years ago, which I found staggering, myself, and that we went through two serious recessions in reaction to high inflation rates.

Second, the imposition of price and wage controls and, to a lesser degree, attempts to control prices directly by incomes policy, which contributed to inflation and instability.

Third, undertaking and maintaining commitments to enlarged transfer payments to middle and upper income people, mainly through Social Security and Medicare, which grew far beyond the original estimates and limited the Nation's ability to pursue more important objectives.

Fourth, making an excessive tax cut and refusing to restore the revenue loss adequately thereafter, which also limited the Nation's ability to deal with pressing problems.

And, fifth, adopting an increasingly protectionist stance on international trade in the 1980's, which reduced the efficiency of the economy and irritated relations with our allies.

None of these mistakes was due to inadequate institutional arrangements or organizations or procedures for the making of economic policy. Each was made by the officials of government who properly had the responsibility and the authority. In each case the officials were advised by the people who should have been advising them. In each case the decisionmakers had access to all the known information. The decisions were not made hastily. They were made with deliberation and they were made repeatedly. They were not accidents.

Although I can think of changes in the organization and procedure of economic policymaking that look like improvements, I cannot claim that any of them would make a significant difference in the outcome. The causes of our mistakes are more fundamental. In my opinion, they are these.

First, there is an inadequate conception of the national interest and of the relationship of economic policy to it. The view of the na-

tional interest held by the decisionmakers and the public has been too narrow and shortsighted.

Second, there is a divergence between the national interest and the perceived interest of the decisionmakers. Perhaps it is psychologically more accurate to say that they tend to identify the national interest with their own interest.

Thus, a Federal Reserve Chairman who regards himself as a determined fighter against inflation may still run an expansionary policy that risks inflation because he believes that if he does not do so Congress will deprive the Federal Reserve of its independence, with the consequence of even more inflation.

Ronald Reagan could think that the benefit to the Nation from his becoming President outweighed the risks of the big tax cut he was promising as part of his campaign to get elected.

Third, there is a lack of information. There are things that no one knows, or knows for sure. I do not think that such ignorance by itself is a major cause of our big mistakes. It does, however, become important when it interacts with the private interests of the decisionmakers.

For example, we do not know for sure that cutting tax rates will not raise the revenue. But we can say that the odds are 90 to 10 against it. It is the 10 percent chance that enables the policymaker to convince himself and possibly to convince others that cutting tax rates is a way to raise the revenue.

Politicians justify themselves by saying that they are only doing what the public wants. But that is not sufficient. Our leaders, including our elected officials, have a responsibility to do more than listen to the public sentiment and follow it. They have a responsibility to inform the public of what their options are, of what the consequences of alternative policies would be, and of where they think the national interest lies. They have a responsibility to tell the public what the public may not want to hear.

In my opinion, the single main reason for our mistakes in national economic policy is the unwillingness of our leadership to tell the American people the unpleasant truth that the results they seek have their costs. I believe that the people would welcome candor and respond to it.

The fault is not entirely with our political leadership. In fact, one has to understand the limitations under which the political leadership operates. There need to be other authoritative, responsible, independent and respected voices in the country, and we suffer from their absence.

I will turn now to somewhat more specific comments on two critical areas, monetary policy and the budget.

The Federal Reserve System is the standard object of suggestions for organizational and institutional changes for two reasons.

First, its position in the Government is anomalous because it has a large degree of independence and very important powers.

And, second, its responsibility as guardian of the currency requires it frequently to take measures that, at least in the short run, are unpopular.

Thus, we get repeated proposals to put the Secretary of the Treasury on the Federal Reserve Board, to change the terms or numbers of Board members, to eliminate the Open Market Com-

mittee, to put the Fed in the budget, to have the Fed audited by the General Accounting Office, and so on.

In my opinion, none of these proposals gets anywhere near where the problem is. The trouble with monetary policy in the past 30 years has been a persistent tendency to excessive expansionism. One reason for this is that the country is not firmly committed to price level stability. The Federal Reserve cannot count on the White House and the Congress supporting it if its efforts to stabilize the price level cause temporary increases of interest rates or of unemployment, as they sometimes will.

The Fed has no directive from Congress to make stabilizing the price level its highest priority. If problems arise as a result of efforts to stabilize the price level, the Fed has no defense. It cannot say that they were carrying out the mandate of Congress.

Oddly, and this is part of the problem, Congress has given the Fed no directions at all. It has given it lots of power with only the vaguest indication of what the power should be used for.

The most useful thing that Congress could do to improve the future conduct of monetary policy would be to pass a law stating its view that stabilizing the price level should be the first objective of the Federal Reserve.

Finally, a few words about the budget. In my opinion, national policy about the major aggregates of the budget has not floated totally free of reality. The decisions are not made on the basis of realistic consideration of what their economic and social consequences are.

Instead, we find ourselves playing an arbitrary game with arbitrary rules. The game is to maneuver an arbitrarily defined ball, called the deficit, around arbitrary obstacles, like "No New Taxes" and "Social Security Off the Table" into an arbitrary hole, called the Gramm-Rudman deficit target, and the penalty for failure is an arbitrary masochistic punishment named "sequestration."

Neither the definition of the deficit, nor the size or sign of the target nor the constraints imposed have ever been seriously discussed in terms of their real significance for life in America or for what may be considered the proper objective of government policy. We play this game because it is easier than facing the real choices that confront us. If the game becomes too difficult, we can change the rules, as we just did in the case of the savings and loan bailout.

It is time we started facing our real choices. We have to stop saying that we cannot afford to do this or that, when all we mean is that we cannot afford it within the rules of the game we have arbitrarily established and agreed to play.

What we should mean when we say that we cannot afford to spend a certain amount of money for drug control, or for education or for assistance to poor people or for national security is that we prefer to spend the money on something else. Then we could have a debate about whether one use of the money was more valuable than some other, which is what rational budgeting is about.

We would also see that the alternative uses among which we have to choose are not the different direct government expenditures within the $1.1 trillion budget. They are the different uses of the $5 trillion that is the national output.

The Federal Government is profoundly influencing the allocation of the entire national output among its major uses, among consumption, investment, health care, education, and defense, for example. Budgeting should start with a national discussion of the way the national output is now being allocated, how that conforms to national objectives, how it should be changed and by what means.

We need a new way of looking at the budget that is suited to the present and inescapable role of the Government in this society. We need to do more consciously and intelligently what we are doing anyway, but without awareness and information.

I have discussed this way of looking at the budget in a recent book, "Governing the $5 Trillion Economy," and in a recent article in Challenge magazine, which I have attached to my prepared statement.

I think that it would be highly appropriate for this committee to take the lead in fostering this new approach to the budget. And I might remind you that this committee 9 years ago, in 1980, took a step in this direction by publishing a report on the functional allocation of the GNP and a GNP approach to the budget in a study done by Frank Ripley.

Thank you.

[The prepared statement of Mr. Stein, together with the article from Challenge magazine, follows:]

PREPARED STATEMENT OF HERBERT STEIN

There have been many mistakes of economic policy in the experience of all of us present today--say in the past thirty years. It is appropriate that this committee should consider why these mistakes were made and how similar mistakes might be avoided in the future.

To do this we must start with an idea of what the mistakes were. In my opinion the chief mistakes were these:

1. A persistent tendency to overly-expansive monetary policy, with the result that consumer prices are now 4 1/4 times as high as they were thirty years ago and that we went through two serious recessions in reaction to high inflation rates.

2. The imposition of price and wage controls and, to a lesser degree, attempts to control prices directly by incomes policy, which contributed to inflation and instability.

3. Undertaking and maintaining commitments to enlarged transfer payments to middle and upper income people, mainly through Social Security and Medicare, which grew far beyond the original estimates and limited the nation's ability to pursue more important objectives.

4. Making an excessive tax cut in 1981 and refusing to restore the revenue loss adequately thereafter, which also limited the nation's ability to deal with pressing problems.

5. Adopting an increasingly protectionist stance on international trade in the 1980s, which reduced the efficiency of the economy and irritated relations with our allies.

None of these mistakes was due to inadequate institutional arrangements or organization or procedures for the making of economic policy. Each was made by the officials of government who properly had the responsibility and the authority. In each case the officials were advised by the people who should have been advising them. In each case the decision-makers had access to all the known information. The decisions were not made hastily. They were made with deliberation and they were made repeatedly. They were not accidents.

Although I can think of changes in the organization and procedure of economic-policy making that look like improvements, I cannot claim that any of them would make a significant difference in the outcome.

The causes of our mistakes are more fundamental. In my opinion they are these:

First, there is an inadequate conception of the national interest and of the relationship of economic policy to it. The view of the national interest held by decision-makers and the public has been too narrow and short-sighted. Policy was too inflationary throughout because immediate gains in employment and output were valued above the interest in long-run economic stability and growth. Excessive tax cuts were made, and benefit commitments to middle and upper income people were entered into, because the initial gains in consumption were valued more than

ability to deal with problems of national security, poverty, education, drugs and crime. Protectionist measures were adopted because the interests of certain industries were valued above the interests of consumers in general and of our international political relations.

Second, there is a divergence between the national interest and the perceived interest of the decision-makers. Even to the extent that decision-makers perceive the national interest correctly they undervalue it because it seems to conflict with their own interest. Perhaps it is psychologically more accurate to say that their perception of their own interest prevents them from valuing the national interest correctly. Or, they tend to identify the national interest with their own interest.

Thus, a Federal Reserve Chairman who regards himself as a determined fighter against inflation may still run an expansionary policy that risks inflation because he believes that if he does not do so Congress will deprive the Federal Reserve of its independence, with the consequence of even more inflation. President Nixon could impose temporary price and wage controls, even though he recognized their evils, because he thought that otherwise the presidency would fall into the hands of someone who would make such controls permanent. Ronald Reagan could think that the benefit to the nation from his becoming president outweighed the risks of the big tax cut he was promising as part of his campaign to get elected.

Third, there is a lack of information. There are things that no one knows, or knows for sure. We do not know how much the inflation rate will change if the rate of growth of the money supply changes by a given amount. We do not know how much national expenditures for health care—including private as well as public expenditures—will change if

we change Medicare expenditures by a billion dollars. I do not think that such ignorance by itself is a major cause of our big mistakes. It does, however, become important when it interacts with the private interests of decision-makers.

For example, we do not know for sure that cutting tax rates will not raise the revenue. But we can say that the odds are 90 to 10 against it. It is the 10 percent chance that enables the policy-maker to convince himself and possibly to convince others that cutting tax rates is a way to raise the revenue.

Each of the big mistakes of economic policy that I have listed was extremely popular. Imposing the price and wage controls was probably the most popular thing that President Nixon ever did. Cutting taxes was probably the most popular thing that President Reagan ever did, except possibly for bombing Libya.

Politicians justify themselves by saying that they are only doing what the public wants. But that is not sufficient. Our leaders, including our elected officials, have a responsibility to do more than listen to the public sentiment and follow it. They have a responsibility to inform the public of what their options are, of what the consequences of alternative policies would be, and of where they think the national interest lies. They have a responsibility to tell the public what the public may not want to hear.

In my opinion, the single main reason for our mistakes in national economic policy is the unwillingness of our leadership to tell the American people the unpleasant truth that the results they seek have their costs. I believe that the people would welcome candor and respond to it. The fault is not entirely with our political leadership. In fact,

one has to understand the limitations under which the political leadership operates. There need to be other authoritative, responsible, independent and respected voices in the country, and we suffer from their absence.

I will turn now to somewhat more specific comments on two critical areas of economic policy--monetary policy and the budget.

The Federal Reserve System is the standard object of suggestions for organizational and institutional changes, for two reasons. First, its position in the government is anomalous. It has an unusual degree of independence from elected officials and still has authority over one of the most powerful of government's instruments--the control of the money supply. Second, its responsibility as guardian of the currency, which means as the guardian of price level stability, requires it frequently to take measures that at least in the short run are unpopular. As former Fed Chairman, William McChesney Martin, used to say, they have to take the punch bowl away just as the party is getting interesting. The combination of factors leaves the Fed exposed to complaints, including complaints from elected officials in the White House and the Congress who want to blame the Fed for all unpleasantness, as if the price level could be stabilized without unpleasantness. They like to claim that if only the Fed were organized differently, such unpleasant things as rising interest rates and occasional economic slow-downs could be avoided. Thus we get repeated proposals to put the Secretary of the Treasury on the Federal Reserve Board, to change the terms or numbers of Board members, to eliminate the Open Market Committee, to put the Fed in the budget, to have the Fed audited by the General Accounting Office, and so on.

In my opinion all of these proposals, if implemented, would do more harm than good. None of them gets anywhere near where the problem is. The trouble with monetary policy in the past thirty years has been a persistent tendency to excessive expansionism. One reason for this, probably the chief reason, is that the country is not firmly committed to price level stability. The Federal Reserve cannot count on the White House and the Congress supporting it if its efforts to stabilize the price level cause temporary increases of interest rates or of unemployment, as they sometimes will. The Fed has no directive from Congress to make stabilizing the price level its highest priority. If problems arise as a result of efforts to stabilize the price level the Fed has no defense. It cannot say that they were carrying out the mandate of Congress. Oddly, and this is part of the problem, Congress has given the Fed no directions at all. It has given it lots of power with only the vaguest indication of what the power should be used for. This preserves the freedom of the Congress more than it sustains the independence of the Fed. In fact, about 15 years ago the Congress created a procedure by which it could give the Fed some instructions and, incidentally, thereby, share some of the Fed's responsibility. It provided for periodic, now semi-annual, reports by the Fed on its past performance and future plans. Congress or its committees could take that occasion to criticize what has been done and to indicate what should be done. I do not believe that Congress has ever taken that opportunity.

The most useful thing that Congress could do to improve the future conduct of monetary policy would be to pass a law stating its view that stabilizing the price level should be the first objective of the Federal Reserve. This has been proposed in the past, but its proponents have

been afraid to push the idea. They have been afraid that the proposition would be rejected, in which case the Fed would be even more exposed than it is now. But it is time to be more mature about this. The government should be more explicit about what its price level objectives are and provide the Federal Reserve with a standard to which it can adhere.

Finally, a few words about the budget. In my opinion, national policy about the major aggregates of the budget has not floated totally free of reality. The decisions are not made on the basis of realistic consideration of what their economic and social consequences are. Instead we find ourselves playing an arbitrary game with arbitrary rules. The game is to maneuver an arbitrarily-defined ball, called the deficit, around arbitrary obstacles, like "no new taxes" and "Social Security off the table" into an arbitrary hole, called the Gramm-Rudman deficit target. Neither the definition of the deficit, nor the size or sign of the target nor the constraints imposed have ever been seriously discussed in terms of their real significance for life in America or for what may be considered the proper objects of government policy. We play this game because it is easier than facing the real choices that confront us. If the game becomes too difficult we can change the rules, as we just did in the case of the Savings and Loan bail-out.

It is time we started facing our real choices. We have to stop saying that we cannot afford to do this or that, when all we mean is that we cannot afford it within the rules of the game we have arbitrarily established and agreed to play. What we should mean when we say that we cannot afford to spend a certain amount of money for drug control, or for education or for assistance to poor people or for

national security is that we prefer to spend the money on something else. Then we could have a debate about whether one use of the money was more valuable than some other, which is what rational budgeting is about. We would also see that the alternative uses among which we have to choose are not the different direct government expenditures within the $1.1 trillion budget. They are the different uses of the $5 trillion that is the national output.

The government's borrowing and taxing policies are profoundly influencing the amount of investment by Americans, including both private and public investment. Its tax and transfer policies are influencing the amount of private consumption, and how much of that is done by poor people and how much is done by people who are not poor. The government is greatly influencing the total amount spent for health care in the U.S., including private expenditures as well as public expenditures. The government, in other words, is greatly influencing the allocation of the whole GNP among its major alternative uses. This influence is inescapable and is related to objectives in which there is a national interest. Budgeting should begin with recognizing this fact and trying to deal with it as explicitly as possible.

We need a national discussion of the way the GNP is allocated among its major uses. We need to consider whether the existing allocation is consistent with national objectives. Are we satisfied that 55 percent of the national output goes for the consumption of people who are not poor, excluding expenditures for health care, 12 percent for health care and 2 percent for the consumption of the poor? Is 14 percent of the national output going to investment by Americans sufficient, or excessive; is 6 percent for education consistent with the priority we give to e ucation?

One may say that such questions are none of the Federal government's business. But the fact is that the Federal government is now answering such questions, and the only issue is whether it should know and reveal what it is doing or not.

In short, we need a new way of looking at the budget that conforms to the present role of the Federal government in the society. I have described this way of looking at the budget in a recent book, Governing the $ 5 Trillion Economy, and in a recent article in Challenge magazine, which I attach to this statement and would like to have placed in the record.

I believe that it would be highly appropriate for this Committee to take the lead in fostering this new approach to the budget. The Joint Economic Committee was originally an outgrowth of what I have called the first fiscal revolution. This was the idea that stabilizing the economy, or achieving full employment, was the prime responsibility of fiscal policy, which was the prime instrument for achieving that objective. The Joint Economic Committee was established to look at fiscal and other policies of government in terms of that overarching objective and to provide guidance to Congress about the implications of that view. Now we have to recognize a new overarching or synthesizing function, the allocation of the national output. This would be a fitting subject for the JEC to put at the top of its agenda.

In fact, the JEC has already taken one step in this direction. In 1980 it commissioned and published a study, "Postwar Trends in the Uses of the National Output—A GNP Budget Approach," by Frank C. Ripley. The study estimated the allocation of the GNP among major functional categories in the past and tried to calculate how different Federal

policies would affect that allocation in the future. This beginning needs to be followed up. Specifically, this Committee might do three things:

1. Induce the Department of Commerce to make estimates of the past allocations of the national output, which they can do better than anyone else.

2. Encourage private economists to try to develop models of the relations between government policies and the allocation of the national output.

3. Provide a forum in which thoughtful people could discuss the appropriateness of the existing allocation of the national output, desirable changes in it, and policies by which desirable changes might be brought about.

I am confident that if more people can be brought to think and talk about the budget in a functional way--in terms of the real effects that we are and should be interested in--improvement of policy will surely follow.

HERBERT STEIN

America's Second Fiscal Revolution

The government eventually will be responsible for allocating the entire national output, not just the federal budget. Expenditures, taxes, and deficits will be viewed more and more as instruments for achieving our national goals.

The Great Depression of the 1930s, with an assist from John Maynard Keynes, created a fiscal revolution in America, a new way of thinking and acting about the budget. Before the revolution, the budget problem was how to provide and pay for a limited list of uniquely government functions absorbing a small fraction of the national income. Calvin Coolidge, for example, presided over a budget equal to about 3 percent of GNP and devoted almost entirely to defense, interest, care of veterans, the post office, and the administration of justice.

The depression focused attention on the role of the budget as a stabilizer of the economy. It brought us "functional finance," in which the function of the budget was to affect aggregate demand in a way that would yield full employment and, it was hoped, price level stability.

This new way of thinking led to several specific developments. One was the Employment Act of 1946, assigning new responsibilities to the government, with the clear implication that the budget was to be the major instrument for carrying out these reponsibilities. From the Employment Act we got the Council of Economic Advisers (CEA) and the Joint Economic Committee. A natural consequence was the emergence of the Troika as the central body for making economic policy in the executive branch of the government. Comprised of the treasury secretary, the budget director, and the CEA chairman, it reflected the assumed interaction of the budget and the aggregate performance of the economy.

The view of stabilization as the critical economic function of the budget gave rise to new ways of measuring the budget—the unified budget, the national income accounts budget, and the high employment budget—and to much research by economists on the relations between the budget, total output, employment, and the price level. And, to a considerable de-

HERBERT STEIN is a Senior Fellow of the American Enterprise Institute, Washington, D.C., and Editor of *The AEI Economist*.
His new book, *Governing the $5 Trillion Economy*, was written for the 20th Century Fund and published by Oxford University Press in February.

gree, this view of the budget function affected the policy that was actually followed.

I described the history of this first fiscal revolution, up to about 1965, in my book, *The Fiscal Revolution in America* (see For Further Reading). But now we need, and I believe we are in the process of getting, a second fiscal revolution. It is not a revolution counter to the one that began fifty years ago. That revolution already has been subject to much revision. What I am talking about is something entirely different. It deals with the role of the budget as an allocator of the national output, a subject that needs new consideration regardless of how the budget is to be managed in relation to the stabilization problem.

This new revolution will address four basic facts:

(1) The federal budget now directly absorbs, through its expenditures, over 20 percent of GNP.

(2) Probably half of federal budget expenditures goes to nonfederal sectors—private, state, or local—and covers health, education, investment, and most of all, personal consumption.

(3) The federal government strongly influences the direction of uses of the national output that are not ordinarily considered "federal," not only through expenditures, but also through taxes, borrowing, and regulations. Federal borrowing affects private investment. Federal tax provisions affect private spending for health. Federal regulations affect private spending for protecting the environment, and so on.

(4) There is a national interest, justifying government concern, with many of the private uses of the national output that federal policy affects.

Given these facts, it would appear that the government ought to be responsible for the allocation of the entire national output, not just the federal budget. It should use the budget and other policies of government as instruments for effectuating the desired allocation of the national output. It should make the decisions about the desired allocation of the national output as self-consciously, as explicitly, and with as much information as possible. The main object of my new book, *Governing the $5 Trillion Economy* (see For Further Reading) is to explain the importance of this approach and to suggest ways of implementing it.

Using our national output

This way of looking at the budget, this second fiscal revolution, is necessary not only because it would be neat and logical, but also because it addresses today's

Stein's long and distinguished career

Herbert Stein, a senior fellow of the Washington-based American Enterprise Institute (AEI) and editor of *The AEI Economist*, attended Williams College during the Great Depression when he found only one day's work during all of his vacations from school. The state of the economy during those years was what initially propelled him into his long and distinguished career as an economist.

He went on to the University of Chicago for his Ph.D., not because of the growing reputation of its free market Chicago school of economic thinking, but rather because "it was recommended to me by a professor to whom I was close." Later he was instrumental in applying and popularizing the Chicago school as an economist in a series of Washington jobs, including the Committee for Economic Development, where he remained for twenty-two years.

Stein was chairman of the Council of Economic Advisers (CEA) under Presidents Nixon and Ford, and served on President Reagan's Economic Policy Advisory Board (PEPAB). Stein told *Challenge* that the CEA job was the highlight of his career.

"Being inside the White House orbit was very exciting," he said. "In the Nixon Administration, everything could be freely discussed. It was a freer environment than, for instance, the Reagan Administration where some things, taxes especially, were considered taboo subjects for discussion."

When he was on Reagan's PEPAB, he "grumbled and dissented" about the absence of "any logical foundation for the administration's whole budget policy." But his dissatisfaction did not make him any happier with the loyal opposition which he considered "too protectionist, too dovish, too inflationist, too redistributionist, and too tempted by grandiose ideas of economic planning . . ."

Now Stein has written *The $5 Trillion Economy*, in which he outlines a plan for allocating the nation's GNP that seems to endorse a planned economy. "Not so," says Stein. "I don't recommend price controls. I don't recommend controlling entry to industry." Nevertheless he would "like to take the curse off the word 'planning' because in general there's nothing wrong with it. The question is what decisions are you planning to make? Are they legitimate or not?"

In addition to his work at the AEI, Stein is a contributor to The Wall Street Journal and a Congressional Budget Office consultant. Otherwise there is no major project on his immediate agenda. "I'm just resting up," he said. "I'm entitled."

most important economic problem: we are not using our national output wisely. Although we are enormously rich, with a real national output previously undreamed of, we seem unable to do many of the things we expect we should be able to do. We find ourselves lacking in our ability to defend ourselves, educate our children, take care of the poor, and provide for the future. Others might describe our deficiencies differently, but that doesn't change the basic point.

Table 1 **Use of National Output**

	Percent of 1986 GNP
Investment owned by Americans, including government investment	14.3
Defense	6.6
Health care	10.3
Education	6.2
Other consumption of the very poor	1.9
Other private consumption	54.7
Other federal uses of output	1.3
Other state and local uses of output	3.8
Government transfers and interest payments abroad	0.9
	100.0

Source: All data except consumption by the poor from Bureau of Economic Analysis, Department of Commerce, National Income and Product Accounts, and Survey of Current Business. Consumption by the poor based on author's estimates.

What I am saying no doubt immediately raises in some minds the specter of "national economic planning"—a subject on which I have written my share of scandalized criticism. Some imagine a federal czar squeezing the entire national output into the cells of a giant 1,000-by-1,000 matrix of the economy. This is not what I am talking about at all. I am talking about the allocation of the national output among a few—say, ten—uses where the federal influence is large and inevitable, where there is a strong national interest in the allocation, and where the federal influence is exerted without serious discrimination among individuals or power over them.

Table 1 shows the categories I am thinking of, together with an estimate of the share of the national output they absorbed in 1986, the latest year for which necessary data are available.

Others might construct a different list. Some might want to add housing and research, or drop the distinction between consumption of the very poor and other consumption. Such differences are not critical to my proposal. What is important is that the list should exhaust the national output, so that if there is to be more of something on the list there has to be less of something else. The list should carry out the basic principle that the cost of something is the other things that must be foregone to get it.

I can illustrate the meaning of my proposal by referring to the very real issue that first made me think of it. In 1969, when I became a member of President Nixon's Council of Economic Advisers, I was made head of a task force to study the economic consequences of decisions about the size of the defense program. We very quickly realized that the most obvious cost of an increase or decrease of the defense program was that less or more of the national output would be left for nondefense uses.

Moreover, the effect would not be on nondefense uses "in general." Which of several major categories of defense uses would be affected would depend upon policy decisions about finance that would inevitably accompany the defense decision. If a larger defense program were financed by borrowing, there would be less investment, which, in the conditions of 1969, we thought mainly would translate into less housing. If taxes were raised, there would be less private consumption. If federal grants-in-aid were cut, there would be fewer state and local services.

Furthermore, we thought that the question of whether an increase of the defense program was worthwhile could not be separated from the question of which share of the national output would be sacrificed to achieve it. So we were already in the process of thinking about making a budgetary decision within the context of a decision about allocation of the national output among a few major categories.

Being superficial or being explicit

My continuing interest in this subject has been fueled by what has seemed to me the dangerously superficial way in which we have been thinking about the defense program to this day. People keep talking about being unable to "afford" a larger defense program. I think they should be saying that they prefer some other use of the national output, such as private consumption or investment. If people could be induced to be explicit about these preferences, they would make better decisions.

The same superficiality is apparent in the talk about

the federal deficit. We have gotten over saying that a deficit of a certain size is necessary to achieve high employment or is dangerous because it will cause inflation. So we are left with no anchor for considering the proper size of the deficit or surplus—no national objective for which that decision is consequential. We therefore rely on totally arbitrary targets, like Gramm-Rudman-Hollings.

I propose that we look upon the deficit or surplus as an instrument for influencing the amount of investment owned by Americans and determine the size of the deficit or surplus by deciding how much of the national output should go for that rather than for consumption or defense or the other major purposes I would distinguish.

I am trying to demythologize the talk about the budget and deficits and taxes and spending. I want to promote talk about the budget in which expenditures and taxes and deficits are not considered totems, or ends-in-themselves, but are looked upon as instruments for achieving certain uses of the national output. Decisions about these instruments should be made by reference to the character and magnitude of their effects on the allocation of national output.

Thinking about the budget *initially* as an instrument for allocating the national output has three main advantages:

(1) It gets us closer to the goals we are really interested in rather than just thinking about variables like deficits and taxes. Of course, categories like investment, private consumption, and total health expenditures are not the *ultimate* objects of policy either. But they are much closer to the ultimate objects—"welfare" or "social solidarity" or whatever—than the numbers we usually talk about.

(2) Allocating the national output brings home the point that decision-making involves choice and that if you want more of something you have to have less of something else. The national output is, in the short run at least, a given total, and you cannot allocate more than 100 percent of it. But the size of the federal budget is not a given, and you can always make it appear that more is being given to one purpose without less to another by making the total larger.

(3) Allocating the national output eliminates the possibility and temptation to evade the constraints of the budget by recourse to other policies, such as regulations, that have similar effects. The most notable current instance is the proposal to establish national health insurance by requiring employers to provide insurance for their workers. If one looks only at the federal budget, that seems devoid of cost. But it does involve devotion of more of the national output to medical care and consequently less to something else. A "GNP budget" would reveal that.

A less obvious case would be an effort by the president, as is sometimes suggested, to use his "bully pulpit" to induce states, localities, and private parties to spend more for education. This would also involve a shift in the use of resources, which would have its costs, and, if the amounts were large enough, they would show up in the "GNP budget."

Of course, I am not suggesting a law enacting the "GNP budget" and saying how much of the national income should go for investment or for consumption or for others of the grand categories that would be identified. I am only talking about a framework for thinking about and discussing the budget and for proposing and evaluating the specific tax, expenditure, borrowing, lending, and regulating programs of the government.

Setting priorities

I visualize a president some day saying, in his state of the union message, what he thinks the country's main priorities are. He would tell us what he thinks we most need—whether it is more economic growth to provide for the future, or a higher standard of living for the great mass of Americans, or strengthened national security, or whatever it may be. He would indicate what changes in the allocation of the national output would conform to those priorities—what changes in the proportions of the national output should go to investment, or to private consumption, or to defense. And, if he suggests that some uses should be increased, he would have to suggest which uses should be reduced.

All of this would be preliminary and explanatory, but the president would base upon it a set of specific proposals for taxes, expenditures, lending, borrowing, and regulations intended to conform to those priorities. The statement of priorities and desired allocations of the national output, at the level of generality that I am suggesting, would not uniquely determine the specific proposals.

For example, if the desire is to reduce the share of the national output going to consumption by Americans who are not poor, there still remain many questions about how to do that. Should taxes be raised? If so, which ones? Should social security benefits, or farm subsidies, or other transfer payments be reduced? Similar questions would be raised about the

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means for implementing other goals for the allocation of the national output. At this point all the usual questions about equity and efficiency would arise, but they would arise within the context of some objectives that had been explicitly stated.

Many of the proposals made these days for reforming the budget process would fit comfortably with the suggestions I have made. We need, for example, a longer-run—four- or five-year—budget to guide the major expenditure and revenue decisions. We need two-year appropriations. We need to reduce drastically the number of appropriation items into which the budget is divided, in order to focus the attention of Congress on the big issues and cut down on micromanagement. We need cooperation between the White House and the congressional leadership in the early stages of budget development. My proposal would put another level of decision-making on top of all that in order to relate the usual tax and expenditure actions to the grand allocations of the national output and through that to the grand national priorities.

Two complaints

Aside from the worry about "planning," which I have already discussed, the proposal to "budget the GNP" has elicited two main complaints. One is whether we know enough to do what is proposed. The idea assumes that we know that if we reduce the deficit, savings and investment will increase, and by how much. It assumes that we know that if we raise taxes, consumption will be decreased, and by how much. It assumes that we know how national expenditures on medical care will be affected if we alter the tax treatment of employers' contributions for health insurance.

We do not, however, "know" such things, if knowing means knowing precisely and with a high degree of reliability. No one is more aware of this than I am, or, at least, no economist has written about our ignorance so much. Though this ignorance is a problem, it is not, in my opinion, a serious objection to my proposal.

The decisions we are now making, and cannot escape making, already imply some answers to questions that we cannot answer precisely and reliably. When these implied answers are exposed to the light of day, we may discover that they contradict what little we do know. Perhaps we will find that the implied answers assume that we know with confidence something that we do not really know at all.

For example, policy about taxation assumes that we *know* that a tax increase will be fully matched by an

expenditure increase, or that it will depress the economy, or that it will reduce saving by an equal amount, or that it will reduce the revenue. The possibility of prudent decisions would be enhanced by a revelation of the true state of our knowledge about these questions. As Artemas Ward said, "It ain't what we don't know that hurts us, it's the things we know that ain't so."

Allocating the GNP would be a step toward revealing what we need to know anyway in order to make intelligent decisions and toward exposing what we do and do not know. One consequence would be to direct attention to trying to learn more. The second fiscal revolution provides a research agenda for economists, just as the first revolution did, although I hope no one will think that is the motive for it.

One of the most elementary things we need is a more reliable classification of the national output by uses or functions. For example, we cannot now tell very well how much of the national output goes for education or medical care because in the national income accounts much of the expenditure for these functions is included in the costs of producing other goods and services.

Another major complaint about my proposal is that "It may be good economics, logical and rational, but it isn't politically realistic." Politicians, it is said, have no interest in good economics, logic, or rationality. They do not want to expose the consequences of their actions any more than they have to and they are certainly not looking out for something called "the national objectives."

I have lived in Washington, in and around government, for 51 years and have heard this argument repeatedly. (I also have been in Washington long enough to learn that politicians, political scientists, and political journalists do not know very much about what is "good politics.") I appreciate the force of the argument, but I do not think it is an insuperable objection to trying to introduce more information and rationality into the process, for several reasons:

(1) There really is no alternative. Some people think there is an alternative, which is to impose upon "uninformed and unprincipled politicians" a set of rules devised by "outsiders" who are both "informed and principled." Balanced-budget amendments and expenditure-limitation amendments are examples of such rules. But we now see how difficult it is to get the politicians to put those blinkers on, and Gramm-Rudman-Hollings shows how adept the politicians are at evading the rules if they do not accept the reasons for them.

In any case, such rules at best can only deal with the big aggregates, such as the size of the deficit or total spending. They can not deal with questions of the direction of expenditures, which may be more important.

(2) The utility of my proposal does not depend upon politicians becoming "good," in the sense of more public-spirited and honest. I assume that the politicians will strive to serve their own interests, with as high or as low ethical standards as ever. I only want to transfer the struggle to a better-illuminated playing field. I want the participants to be better informed about the consequences of what they are doing and, especially, of what is being done to them.

The errors of policy, from the standpoint of the national interest, are partly due to the difference between the interest of the decisionmakers and the national interest. But policy errors are also, and to a considerable degree, due to ignorance all around. It is this second cause of error that I hope to correct. I do not know what to do about the first.

(3) The budget reform movement that has been going on in the United States for at least seventy-five years has always been an effort to inject more information about the ultimate consequences of decisions into the decision-making process. This movement has had considerable success over that period.

Even in recent years there has been progress. The Budget Reform Act of 1974, the increased emphasis on broad categories and long periods in making decisions, the "budget summits" between the White House and the congressional leadership, the general agreement on the need for two-year appropriations, even Gramm-Rudman-Hollings, for all its faults, are steps forward. The proposal to put the decisions in the framework of the allocation of the national output is a logical step in this process and there is no reason to despair of achieving it.

(4) In my opinion, movement toward this new way of looking at the budget and other government policies is not only possible but also highly probable, simply because some participants in the struggle will find this movement in their interest. Proponents of higher defense spending, whatever their motives, will not be content with the answer that we cannot afford it. They will want to know why a 10 percent increase in defense spending is less valuable to the nation than a 1 percent increase in private consumption.

Opponents of mandated national health insurance will ask why we should increase the share of the national output going to medical care—even if it doesn't show in the budget—when the already-high share

shows little benefit. The argument about the size of the budget deficit already is becoming an argument about the share of the national output going to investment, and the consequent effects on economic growth. The competition of claims on the national output will be forced into the arena of real effects because some of the claimants will find their strongest case there and others will have to join them.

I do not count upon politicians alone for improvement of the policy-making process. Much of the leadership in this direction has always come from the private sector, where there are some people with broader and longer interests than politicians may think they can afford. If the public discussion of budget policy focuses on real affects, rather than on symbols and shibboleths, the politicians will have to follow.

Representative HAMILTON. Well, thank you for your statements.

We want to focus on U.S. economic policymaking and procedures. I was first impressed by what appears to me to be a difference in the testimony.

Mr. Gramley, you conclude, "I do not see any major deficiencies in present procedures for making monetary policy or for coordinating fiscal and monetary policies," and that the policy errors that you and Mr. Stein refer to do not stem from deficiencies in procedures, but simply bad judgment.

Mr. GRAMLEY. That's correct.

Representative HAMILTON. Mr. Stein, as I understand it, your view is similar. You say in your prepared statement that "none of these mistakes was due to inadequate institutional arrangements or organization or procedures for the making of economic policy," and then you identify for us why you think the mistakes are made.

Ms. Rivlin, you take, it seems to me, a little different tack. Although you recognize in your statement that the contribution that procedural reform can make is limited, you nonetheless say that "at present U.S. economic policy processes leave much to be desired" on the four standards that you set forth.

And in your speech, which I saw in the American Economic Review, you really identify quite a few procedural suggestions to improve economic policymaking, some seven or so.

Ms. RIVLIN. Yes, but if I may interject, Mr. Chairman, I would concur that our major policy mistakes have not been made for procedural reasons. They have been made for reasons of bad judgment. I think there are things we can do to make procedures better, but I would not expect very different outcomes either.

Representative HAMILTON. OK, that's the point that I wanted to get at, and I appreciate your comment.

Now, why do we make these mistakes, Mr. Gramley? Looking back on these mistakes which you identify, and obviously with the advantage of hindsight, they just look enormous, and how could we possibly have missed at the time?

Mr. GRAMLEY. I think Mr. Stein made a very good point when he said sometimes decisionmakers confuse their own interests with the national interests.

I do think more generally the fact that we have had as much inflation as has occurred in the past 25 years is a consequence of the fact that we really didn't realize until the late 1970's how damaging inflation could really be. It took us a while to learn that lesson, and I hope we have learned it now.

Representative HAMILTON. Do you think that Mr. Stein is right when he says that the big mistakes we made in economic policy came about because our political leadership didn't have the guts to make the right decision? That's basically what he's saying, right?

Mr. STEIN. That's what I'm saying, yes.

Representative HAMILTON. Is that what you think?

Mr. GRAMLEY. Well, I think that's certainly an important factor. I would also argue, as Mr. Stein did, that lack of knowledge sometimes leads us into mistakes and the fact that we confuse our own personal interests or other political interests with the national interests compounds the felony.

I don't think when madatory wage-price controls were put on in the early 1970's, to use one example, that there was any conception that what would evolve would be a highly stimulative set of monetary and fiscal policies to the point where we literally blew those wage and price controls out of the water, and I don't think our political leadership at that time understood how severe the allocational effects would be.

Representative HAMILTON. I'm very much interested in Mr. Stein's comment because he really in a very polite way gives a very strong indictment of political leadership in his statement. We cannot recognize, he says, the national interest. That's what he's saying, and he is saying it very bluntly.

Is that your view, that we cannot, that the political leadership of the country cannot recognize the national interest on these big economic questions?

Mr. GRAMLEY. I wouldn't put it that strongly. I would say sometimes we take too short run a view of what the national interest is. Let me comment just briefly, for example, on the carping that has been going on in the past month or so by the administration about Federal Reserve policy.

In this past year we have seen what I would regard almost as an unprecedented success in terms of the ability of the Fed to nip a flowering inflation in 1988 in the bud and to turn monetary policy around in time to avoid a recession, or at least that is the way I would evaluate current trends in the economy. This hasn't been good enough for the administration.

The person in the administration who probably has been kindest to the Federal Reserve, the Chairman of Council of Economic Advisers, Michael Boskins, recently said the other day, I think, that the administration and the Fed have one common objective, which is to maintain the maximum degree of sustainable growth without inflation.

Well, if the attitude of policy is to maintain the maximum degree of sustainable growth, with concerns about inflation coming behind, we are surely going to make the wrong decisions, but that's the sort of natural propensity of any administration in power to want to squeeze as much output out of the economy as possible.

The inflation we'll deal with later. Inflation is a very sluggish variable, and we probably won't see that for 4 or 5 years ahead. That's a serious problem in decisionmaking.

Representative HAMILTON. I have been quoting Mr. Stein liberally here, and maybe he wants to defend himself.

Mr. STEIN. I don't feel I need to defend myself. No, I think that the problem is basically one of leadership and courage in leadership. I think, if I look at our more immediate situation, we cannot have any kind of responsible discussion of the question of whether we need a tax increase in this country, because no responsible person, hardly anybody outside the political arena, as well as none of those within it, is willing to stand up and say, that's what we need, because that is a taboo. It is considered that if you say such a thing you are obviously right off the table as far as further influence and standing in this country is concerned.

Now why is Social Security off the table? I mean everybody realizes that these are choices. I think people realize those are the

choices that we have to make, but it takes a good deal of courage, if you are responding to what you think public sentiment is, to stand up and tell the American people that.

I think in the case that Mr. Gramley mentions, when I was an inside observer of the imposition of the wage and price controls, I think that all these options had been explored thoroughly and we said to ourselves over and over again, and I had written many times, and Paul McCracken had written many times, and George Shultz had written many times, that one of the dangers of wage and price controls is that when you get into it you get expansionist aggregate policy and that blows the thing out of the window.

But it became irresistible because at one point, as Mr. Nixon said, it's fortunate that we are the ones who do this because we can strangle this baby in its cradle if it gets to be too strong, and if we don't the other people will come along and they will keep it on forever.

But, also, he was under a great deal of pressure from Republicans in the Congress who were unwilling to say to their constituencies that there is no simple solution to this inflation problem and you have to go through this period of restraint in order to get the inflation down. Nobody wanted to face those choices and tell the American people of those choices.

And I mean seriously what I said about the need for responsible leadership outside the political process. I understand that people in the political process have to run for office every 2 or 4 years or 6 years, and that limits them. But I think nostalgically there was a time in which we had some leadership in this country that was not in the political process. We had leaders of industry, and there was a time when people used to pay attention to what university presidents said, and so on. That is, there were people who had more tenure in the world and were not dependent on public opinion and who I think provided some leadership. We seem to be very lacking in that.

I think that we have a moral problem, a problem of civic responsibility, but it's not confined to politicians.

Representative HAMILTON. Ms. Rivlin.

Ms. RIVLIN. I think I would put it slightly differently. The basic problem, it seems to me, is the unwillingness of political leaders to credit the American people with good sense and understanding that choices are necessary. The process and its complexity contributes to that. It doesn't make it easy to communicate what really is at issue.

Representative HAMILTON. Would you agree with Mr. Stein's comment that the big mistakes we have made in each case were extremely popular; that is, the way we decided to go was a very popular decision?

Ms. RIVLIN. Oh, sometimes. I don't think that it was forced by a popular outcry. Take the deficit, for instance, which is on everybody's list of mistakes. It certainly was popular to propose a tax cut, but one could have proposed a smaller tax cut and still have been popular. One could have faced the deficit sooner, I think.

Representative HAMILTON. Do you have the same kind of view that Mr. Stein has of the political leadership, that it's incapable of

making these tough decisions, or at least it hasn't made the tough decisions consistently enough?

Ms. RIVLIN. I was trying to put it a little differently. I was saying that the political leadership is afraid to pose the tough questions to the public. They are afraid they won't get reelected, and I think that may not be true.

Mr. STEIN. I would like to state my agreement with Alice Rivlin on that point. I have never run for anything and I don't know what the public response would be, but I think there is a tendency to underestimate the willingness of the American people to make a sacrifice and to accept difficulty if the need is explained to them by somebody whom they respect. I think the American people have shown that over and over again in big matters and in small matters. So I think that Alice Rivlin is correct about that, that the risks of candor are overestimated.

Representative HAMILTON. Well, you talk about the need for other authoritative, responsible, independent, respected voices, and you're referring there to the nongovernmental sector, the nonelected officials. Who are you referring to there?

Mr. STEIN. I think in the first place of leaders in the business community, and I think of that mainly because of my own experience at the end of World War II and for some years thereafter with the Committee for Economic Development when there were a group of businessmen who took the lead in supporting a free-trade policy and supporting a policy of active government use of fiscal means to stabilize the economy, things that were kind of unorthodox in the business community, but which they felt the country needed.

I think there was a period, as a result of the Depression and the war, when people felt that the country was in a great crisis and were willing to behave in a more responsible way than they do today. I think there has been a deterioration, but again, as I said, maybe this is just the nostalgia of an old man.

Representative HAMILTON. Mr. Gramley, I'm interested in your comments on the Federal Reserve because you have had a lot of experience there. I guess the core of my interest is the question of coordination between fiscal and monetary policy.

Do you believe that under the existing situation and procedures that we have the right kind of communication between the executive branch, on the one hand, and the Fed on the other? Does that process work pretty well as far as you're concerned? Are you comfortable when you serve on the Federal Reserve Board that you know the intentions clearly of the President with regard to monetary policy, and is there good communication?

Mr. GRAMLEY. I think there is quite good communication. There have been periods in the past 25 years when communication has been better than at other times, but this communications process does not require any kind of formal mechanisms. It requires a willingness on the part of both sides, the administration and the Federal Reserve, to get together, to lay their cards on the table and to talk candidly and frankly. They have frequent meetings. The Secretary of the Treasury over the years has met regularly with the Chairman of the Federal Reserve Board. Historically the members of the Council of Economic Advisers have gone to the Federal Re-

serve Board for lunch once every other week or so, and there is a good deal of staff contact that goes on behind the scenes. There is certainly no lack of informal mechanisms for exchanging information fully.

Representative HAMILTON. Why does a Budget Director and a Chairman of the Council of Economic Advisers go to the press to take indirect, if not direct pot shots at the Fed every now and then?

Mr. GRAMLEY. I wish I could give you a good answer to that question. It has been one of the puzzling phenomena that I have been called by persons in the press repeatedly to explain. The economy is doing very, very well, and the administration is taking pot shots at the Fed.

It has been suggested to me that perhaps the administration is trying to distance itself a little bit from the Fed so that if this economy does weaken and we tip over into recession, the Fed will take the blame.

These sorts of public comments occur all the time and I don't think they bother the Federal Reserve particularly, and I doubt that the course of Federal Reserve policy has been influenced one iota because of them, but if it were influenced it would be almost certain to be counterproductive in the sense that if the Federal Reserve has been planning to take a move toward monetary ease, a comment of this sort by an administration official might well lead the Fed to postpone it for a week or two.

Representative HAMILTON. Do you think the executive branch is saying in private in these informal meetings that you described the same thing they are saying in public?

Mr. GRAMLEY. The words they use are probably a little different but, yes, I would think they were expressing to the Federal Reserve their concern about the possibility that the economy may be weakening to the point of tipping over into a recession.

Representative HAMILTON. Well, we have some other things. Some of our witnesses have suggested that we have had too much coordination sometimes between the administration and the Fed.

Mr. Popkin in testimony before this committee characterized the inflation of the mid- and late-1970's as well underway in 1973, and his suggestion I think was that there was too much coordination between the two institutions on some cases, and I guess the other case was when Mr. Burns was the Chairman of the Fed and stimulated the economy greatly. That was when President Nixon was in.

Well, I have a number of other questions I want to pursue with you, and I've taken a little too much time here.

Congressman Scheuer.

Representative SCHEUER. Thank you, Mr. Chairman.

I found the testimony very interesting and a little bit discouraging.

Mr. Stein, you included all of us when you said that elected officials are pusillanimous who are elected every 2 years, and that includes the House, every 4 years, that includes the President, and every 6 years, and that includes the Senate.

Mr. STEIN. I just make a generalization. I don't mean every one. [Laughter.]

Representative SCHEUER. Well, you certainly dealt with us all in a very evenhanded way, and you included us all into the mix. I guess the evidence is that you're right, that none of these three groups, neither the legislative nor the executive branch seems to be able to bite the bullet and make some of the tough decisions, not on spending, but as I view it, on investment—the investments that are necessary to make our economy productive and competitive and prosperous and to preserve what seems to be an eroding standard of living.

What I would like to ask is what kind of financial or accounting tools and what kind of government institutional tools could be created to present the need for investments before the public and before the House and Senate and before the President? They seem so glaring.

We talk about a drug problem and there is a lot of debate on spending money out of this country for crop eradication overseas, interdiction at our borders, which is almost a total failure. We have never picked up more than 10 or 15 percent of the drugs.

But the simple investments in education that could help young kids make it and give them the pride and the satisfaction of being independent and productive citizens is not something that we seem to be able to deal with.

We have an adult work force that is 25 percent illiterate. We know that there is a tried and proven program called Head Start that helps kids from educationally deprived homes, culturally deprived homes, and economically deprived homes.

We know that Head Start helps to bridge that gap and helps them to be learning ready when they go to school. But yet we only invest in one kid out of six who is an urgent educational risk. I mean, what is more important for our country than creating a human capital that is competent and productive and competitive?

We had a report by a Presidential Commission on Higher Education that said that the time has come to make 2 years of postsecondary education an entitlement for everybody, and that was 40 years ago. That was in 1947, 42 years ago, President Truman's Commission on Higher Education.

But in the last 10 years we have turned grants into loans and made it even more difficult for kids from poor homes to make it to college. What do we need to put the raw data for really compelling decisionmaking before the executive branch and before the Congress so that they will be driven by the sheer logic of it?

All of these investments have a cost-benefit calculus of somewhere around 6 or 7 to 1. In the case of the GI bill of rights where we educated a whole generation of Americans and gave them a ticket to all the higher education they could use, it was like between 7 and 13 to 1. These are investments that any businessman would be horrified not to make.

How can we as a society not make them to assure our future productivity? What kind of tools are needed? What kind of institutional systems and processes are needed to make the high desirability quotient of these investments more clear to the decisionmakers around here?

Mr. STEIN. Well, I think that's a basic question——

Representative SCHEUER. And let me just add one thing, Mr. Stein, because you're an academic. Academics have been writing about this. Benjamin Friedman wrote a book, Paul Kennedy wrote a book and MIT just published a book with seven ways to make our economy more productive and included all of these things. Nobel Prize winning economist Robert Solow, Lester Thurow and you folks at this table have done it. Why is there no institutional way of converting all of this learning and all of this analysis and all of this wisdom into decisionmaking fodder for these individuals in the executive branch and here in the Congress?

Mr. STEIN. Well, I guess you have kind of forestalled my answer, which was to say I have written a book about it. [Laughter.]

But I do say in my book that the problem has two parts. One is information analysis and the other is the quality of the people. I don't know how to improve the quality of the people. So I could just write about the information——

Representative SCHEUER. You're talking about the quality of the people who have to make the decisions in the Congress and the executive branch.

Mr. STEIN. Who make the decisions, yes. And may I just put a footnote down there. I think Paul Kennedy wrote a terrible book since you mentioned him.

But I think that there are ways of looking at this problem which if sufficiently emphasized by all the people that talk about it that would help to clarify the thing and reveal that we have hamstrung ourselves by very arbitrary limits that we place on anything we can do, of which "No New Taxes" is only the most glaring example.

When we say can we afford to spend *x* billion dollars for drugs or for aid for child care or something, we say well, this has to come out of this small pot that is left after you take out interest, defense, all the entitlements and so on, and you're down to a very small comparison.

We have to get over the idea that we are a poor country. That's ridiculous. We are a very rich country.

The other day when President Bush proposed that we should have a new space exploration program to go to Mars or some other place, I've forgotten where they wanted to go, people immediately said well, this was all very well in the time of Jack Kennedy, to have a program like this because we could afford it then, but now we can't afford it.

But today per capita real consumption is twice as high as it was in the time of Jack Kennedy. We are much richer than we were in the time of Jack Kennedy and, of course, we can afford it.

Representative SCHEUER. Mr. Stein, that's exactly the point I'm trying to make. Where are the systems and the processes that tell the President and tell the House and tell the Senate that the American people have the capability of producing not only an Army, a Navy, and an Air Force, but also producing education for their kids?

We are not doing it now. The capital is there, and here are the ways that we can produce the flow of capital to invest in our kids. Starting out from the presumption that we are a wealthy country

and we could be a productive country and we could be a well-educated country.

How do we make the link from your knowledge that we are rich to creating the procedures that will drive us to making the investments in education, all the way from preschool to postsecondary, that will continue our productivity, creativity, and competitiveness?

Mr. STEIN. I think this committee is in a strategic position because it was set up to advise the Congress about the economic framework within which it makes its decisions. You were set up in 1946 when we thought the big problem was how to use the budget to stabilize the economy.

That is now I think a secondary problem, and we have a new problem which is how to use our budget to get the correct allocation of the whole national output, the $5 trillion, and I think you should emphasize that and write reports for Congress about that. I would encourage that. I don't know under whose leadership, somebody in this committee, 8 years ago or 9 years ago, generated that study about the uses of the GNP.

I don't know any single person who is going to be able to break through this crust of artificiality that lays over all our decisions, but I think you have your part to play, and I think you could write a very good report about it.

I think that the Budget Committees have a big responsibility and I would hope that they would look at this thing in a broader way then they now do. I'm going to testify before the House Budget Committee next Tuesday and give the same speech.

I don't feel hopeless about it because I do see some increased recognition that the problem of the deficit is a problem of investment in America. There is all this new interest now in the intergenerational equity problem, which is essentially a problem that this generation is consuming too much to the disadvantage of future generations. Of course, even Mr. Darman recognized that, although having said *a* he never said *b*. But, nevertheless, I think we are learning something.

Representative SCHEUER. Ms. Rivlin.

Ms. RIVLIN. I agree with all of that, but it seems to me it also comes down to the thing I tried to emphasize in my statement, the excessive amount of time and energy that goes into very shortrun decisions.

We need to shift somehow into spending more time on thinking ahead. If you are always running to make the decisions that have to be made on the next fiscal year and it's a full-time job and a total absorption of the Congress, as it has become, then it is much harder to get attention to the longer run and more basic things that need to be decided.

So I think one needs to think about how to make the shortrun decisionmaking process more efficient. Now one way is a biennial budget. It's not that 2 years is so much better than 1 from a budgetmaking point of view. However, if you did it every other year it wouldn't take so much energy all the time and you would have a little bit more time to think about what do we really want to do 10 years from now?

Representative SCHEUER. Well, talking about longrun investments, nothing could be probably more long run than to spend $2,500 a year on a Head Start experience to make a young child productive 15 years from now. If they don't learn how to read, write, and count in the first, second, and third grades, they have effectively dropped out. Their bodies may not leave school until the sixth or eighth grade, but their minds have left when they fail to keep up with their peers.

How do we put on the table the decisions on investing in these kids that haven't been made up to now, or otherwise we would have provided full funding for all 3- and 4- and 5-year-olds who were at severe education risk? Right now we are only funding one-sixth of those kids for a Head Start experience.

How do we present the need for long-term capital investment in our human resources to the decisionmakers and put them at least on a parity with the short-term decisions that have to be made?

Ms. RIVLIN. Well, I'm saying you get people more focused on the longer run, and one way to do that is to get them off the shorter run. You are never going to get a lot of attention to longrun investments in a procedure which is focused on next year's budget deficit exclusively.

Representative SCHEUER. Ought there be some kind of a process whereby as a systematic business we are looking at the state of the economy and the state of our human resources 10 and 15 and even 20 years down the pike, where that is part of a regular process?

Ms. RIVLIN. Oh, I think so. With all the uncertainty that must attach to projections, if you get people thinking about where we want to go and possible scenarios for the future, you can get them more focused on these investment-type decisions.

Representative SCHEUER. Thank you, Mr. Chairman.

Representative HAMILTON. Let me take up a specific problem that concerns me on the budget, and that is the tendency we have to adopt very optimistic economic assumptions in the budget and how you get away from that.

It seems to me one of the problems in our budgeting process is that we have these very optimistic economic assumptions, and the dynamics of that are clear to all of us, and it's clearly in the interest of budgetmakers to adopt optimistic economic assumptions because it means you have to cut the budget less or you have to raise fewer taxes.

What happens in the process is the President sends up his budget based on optimistic assumptions. Congress doesn't challenge that. It doesn't come in with what might be called more realistic economic assumptions, because to do so would make us cut the budget more or increase taxes more.

Is this a big problem in the budget process, and maybe this ought to go to you, Ms. Rivlin, since you've had a lot of experience with the budget, and how do you get around it? It seems to me we start off each year with unrealistic choices because we make unrealistic assumptions.

Ms. RIVLIN. Yes, I think it's a big problem, but I'm less clear about how to get around it. It's a problem for two reasons. First, it invites deferring choices because one can always pretend that the economy is going to be better than it is likely to be. Second, it gen-

erates confusion because there are lots of different estimates based on different assumptions, and it's hard to understand what's going on.

I think it would be good to have an agreed governmentwide forecast. People could still criticize it or say things might turn out better or worse, but one would——

Representative HAMILTON. You mean agreed between the Executive and the Congress?

Ms. RIVLIN. And conceivably the Federal Reserve. One could imagine a way of doing this in which the Congress, the Executive and the Federal Reserve would sit down early on and agree on a forecast that would be used for all purposes. This agreement would not bar administration officials from testifying that they thought things were going to turn out better, but it would certainly make understanding easier.

It's hard to get a mechanism for agreement. There would inevitably be some political bargaining, at least between the Congress and the executive branch. But I think it would be better to have a common forecast than to leave it entirely up to the administration which always has an optimistic bias, whether Republicans or Democrats are in charge.

Representative HAMILTON. Well, so does the Congress actually. It's to our great advantage to be optimistic.

Ms. RIVLIN. Yes, although since you always have representatives of the party that is not in charge of the White House, there is often a tendency to be more realistic on congressional forecasts.

Representative HAMILTON. Mr. Stein.

Mr. STEIN. I have two suggestions, and one has to do with Gramm-Rudman. I really think we ought to scrap Gramm-Rudman, but as long as we have it, we ought to correct this hole in it which says that well, we have a target for a year, 1989 or any year, but if we overrun the deficit in that year, why we just forget that.

Now if we said that if you overrun it 1 year, you have to correct it the next year, there would be a penalty for having made an overly optimistic forecast. If the forecast was overly optimistic, then the active deficit will turn out to be larger than you estimated, larger than the target, and then that will be added to your problem for next year. So you pile up problems for yourself, and it makes it much less attractive I think to give yourself an overly optimistic estimate in 1 year.

The other thing I suggested in my book was that the Federal Reserve, having the responsibility for stabilizing the price level, should set a target for nominal GNP, not only for the next year but for a succession of years, and that target set for nominal GNP set by the Federal Reserve should be the basis of the budget.

This would still leave some room for estimating how that nominal GNP is going to be divided between the price level and real output, but still it sets some limits and I think the Federal Reserve would not have the same incentives to an overly optimistic forecast that the budgetmaking people have.

Representative HAMILTON. Mr. Gramley, do you have any comment on this?

Mr. GRAMLEY. No. I would just say that if you decide to have a joint forecast, how you arrive at that forecast is absolutely critical.

If you construct some sort of a process of negotiation in which the administration has essentially the veto power and the big clout, then surely what you are going to end up with is an overly optimistic forecast and you are going to force monetary policy to be too expansive, because it will be argued that inflation is going to come down and the potential growth of our economy is a lot higher than anybody else really thinks it is and you're going to get the worst of all possible worlds.

Representative HAMILTON. Before going to Congressman Obey, let me just raise one other question, and this arises, Ms. Rivlin, from one of your comments. You're talking about a single department in the executive branch consolidating authority for tax, budget, and fiscal policy, a "Department of Economic Affairs," you call it.

Now that is an interesting proposal, and I was thinking of it in terms of international economic problems. Take trade, for example. In trade matters you get so many departments of government involved, Agriculture, State, Defense, Commerce, and it's very, very hard to work out trade policy in this government of ours, it seems to me.

Is this an area where we need more consolidation, and maybe I ought to direct the question to Mr. Stein and Mr. Gramley because it's Ms. Rivlin's suggestion. Do we need more centralization in the executive branch on economic affairs?

Mr. STEIN. Well, I don't really feel the need for that. I think for one thing that the President needs to have advice about major economic problems from a number of sources. I would hope that the establishment of this overarching department would not deprive the President of constant contact with what is now his Secretary of the Treasury, the Director of the Budget, the Chairman of the Council of Economic Advisers, and other people.

I don't think there is any possibility of getting away from the fact that the Government is a very big enterprise and it's going to be run by some combination of committees, and a great deal depends on how those committees work and how the leadership of those committees works.

My recommendation and my constant prescription for how to organize the making of economic policy is to have George Shultz. I remember the days when I was in the Government and George Shultz was the Secretary of the Treasury and also the President's Special Assistant for Economics, and he brought everybody together. He was the kind of person who could listen to everybody, get everybody's point of view and get everybody involved in the action and everybody went away feeling that he was part of the final decision.

But there are other people in a similar position who would not be able to do that. I think an awful lot depends on personality and style in handling those affairs.

Representative HAMILTON. Ms. Rivlin.

Ms. RIVLIN. I think that is a good illustration of what I was talking about. Many countries do have a finance minister who is the chief economic officer, so to speak. Their equivalent of what we call the Council of Economic Advisers and the Office of Management and Budget generally report to that person. You can achieve that

under our structure only if you have a very strong personality at Treasury.

My suggestion was to institutionalize the strong personality and have a single responsible macroeconomic officer, that you might call the Secretary of the Treasury or you might call something else.

Mr. GRAMLEY. If I might just add a word in this respect, Congressman Hamilton. I think the original conception of the Council of Economic Advisers was to be the honest broker in government, a group of advisers who would level with the President, tell him precisely what his options were, what the bad ones were, what the good ones were and to stop bad things in government from happening.

Over the years I think the Council has departed from that a bit, and indeed during the years of the Reagan administration I think the Council's influence in government declined a good deal, and now it's in the process of being restored again.

If I were to try to find an institutional mechanism which would help to harmonize economic policies better, it would be through a strengthened Council of Economic Advisers.

Representative HAMILTON. Congressman Obey.

Representative OBEY. Thank you, Mr. Chairman.

Mr. Chairman, I just came from the dentist, and I thought it would be more pleasurable to sit here and listen to these witnesses this morning, but as I think of the way that both branches of government have dealt with the budget since 1980, I'm really not sure that's true.

Mr. Stein, I would like to ask you a number of questions. And I must confess that the longer I serve here the more I agree with many of your observations. I just read Mr. Heilbroner's new book in which you were quoted extensively. So I went and got the papers to see what it was that you had said that impressed him.

My concern relates to the questions raised in his book and some of the comments you made in the paper cited in that book.

My observation of the budget problems that we face is that probably the last thing in the world we need is another procedural fix. We have been through a lot of those. It seems to me we still have basically a problem of politics in this country. The Democratic Party politicized the Social Security issue in this decade, and the Republican Party politicized the issue of taxes. So I think as a consequence we have sort of built political walls that prevent either party from being responsible.

I think added to that is the problem that lots of times we really don't know how to define what it is we are wrestling with, and that brings me to two questions I would ask of you.

First of all, in determining what is happening in the economy in general, how would you go about strengthening what it is that we really know as opposed to what we think we know that isn't so because there are continually changing economic numbers, numbers which are estimated tentatively which turn out to be very far off track, as happened this summer, for instance? How would you go about strengthening the information base which is supposed to underlie all of the judgments that everybody in government makes?

Mr. STEIN. I would just ignore those changes from the first estimate to the second estimate. I don't think our problems are wheth-

er the GNP grew 2.7 percent in the second quarter or 1.4 percent. I mean that is really insignificant, and I don't think any decision should be made on the basis of such numbers and certainly not the budget.

I think that the budget problems are really in the arena of what Congressman Scheuer was talking about and what I was talking with him about. We don't know whether the GNP is $5 or $5.1 or $4.9 trillion, but it's a very big number and the question is what are we doing with it and how are we serving the national objectives with this very large amount of output that we have in this country. And the answer to that doesn't depend on how much the GNP grew in the second quarter and the third quarter.

We know it's very rich and it's growing. We don't know whether it's going to grow in the next 10 years by 2.5 percent or by 3 percent, and even that, I think, is not going to make the difference between success in this society and failure in this society. I think, increasingly, that we're learning that being rich isn't everything or isn't even most things.

So I think the kind of information we do need much more of and much better is about the allocation of the national output. How much are we spending for education in this country? We really don't know that from our existing kind of figures because a lot of education is buried in the expenses of businesses, in the Defense Department and so on.

We have very poor information on the distribution of income in this country and we don't know how much of the national income and how much of total consumption is the consumption of very poor people and so on. So I think we could do much better in estimating how our national income is used. Our problem is that we don't use it very well, and maybe if we knew better how it was being used that might become clearer to us.

I think, commenting again on Congressman Scheuer's problem, if we could say to the people that we are only spending 6 percent of the GNP on education and we have a big education problem in this country and we are spending 55 percent of the GNP on the consumption of people who are not poor, we could easily transfer another 1 percent from the consumption of the not poor to education and it wouldn't make much difference to the consumption and it would make a big difference to the education. That's the way I would like to think about this problem. I think the information on that could be greatly improved.

Representative OBEY. Do either one of you have any comments?

Mr. GRAMLEY. I don't disagree with anything that Herb Stein has said. I do think, however, that the major statistical agencies have suffered a good deal in the budget cutting process that has gone not just during the 1980's, but during the latter half of the 1970's as well.

I don't think it's the fact that our statistical system is out of date that caused those recent revisions in the GNP statistics or the retail sales or the employment numbers. Those things happen all the time. We just happened to focus on them more recently than we usually do.

But it is, I think, true that our economy is changing in ways that our statistical programs are not able to keep up with now. I was

privileged to be a member of the Committee on Economic Statistics of the American Economic Association, and the report of that committee has some very general recommendations in it about what should be done and was passed on to the staff of the Joint Economic Committee, and I would hope you would consider seriously what needs to be done to make sure our statistical base doesn't get increasingly out of touch with reality.

Ms. RIVLIN. I would agree with all of that. I also believe that procedural fixes are not what is really necessary. What is really necessary is getting everybody in the institutions that we already have more focused on the future and on the big choices—the big choices about the whole economy, not just about the budget, as Mr. Stein has pointed out.

Mr. STEIN. Can I add one point because I was too negative about improving the statistics because you gave me this example about the quarterly GNP, which I don't think is important. But I think there are important areas of statistics that are quite misleading and which need to be improved.

One is this constant talk we hear about how the United States has become the great debtor country, the world's greatest debtor country. That is based on a totally meaningless set of figures which badly need to be corrected.

Representative OBEY. Well, that leads me into my second question.

You have the question, and let me back up and put the question in context. When we passed Gramm-Rudman I literally attended 118 meetings on Capitol Hill. I quit keeping track after I hit that number, but I attended 118 meetings over about a 60-day period when we were debating each other about what kind of a procedural fix to establish. We are now beginning to go through the same process as we talk about what we are going to do with Gramm-Rudman III come debt ceiling time, and when I think of all of the energy and all of the intellectual fire power which is being brought to that question of how we arrange the deck chairs, I get very frustrated and to me again it focuses on the necessity to really know what it is that we are trying to attack and how serious a problem it is and how it ought to be defined.

How ought we look at the deficit in determining whether or not it is a serious or a livable problem and in determining how it does compare with the past and how it does compare with any other measurements you might want to use? How ought we adjust those nominal numbers in our heads in order to make them as meaningful as possible, in your judgment?

Mr. STEIN. I think we should start with the proposition that the main significance of the deficit is its effect on the supply of private savings that is available for private investment in this country. That is, the deficit is a subtraction from the supply of private savings that can be privately invested, and that subtraction, or addition, in case we have a surplus, has an effect on the rate of private investment owned by Americans in the United States.

So I would start by asking whether we are satisfied with the rate of private investment in this country given the other claims on the national output and our claims that we foresee for the future? In my opinion, we should not be satisfied with this rate of private in-

vestment, especially, and this is a point I always have to make, the rate of private investment owned by Americans and not the investment owned here by foreigners. Therefore we should ask what can the Government do to increase this rate of private investment?

There aren't many instruments, but probably the most powerful thing it can do is to reduce its budget deficit. So I would say that creates a claim for reducing the budget deficit. Now how much? I would start, as I did in my book, by asking what is the rate of private investment we would like to have in this country. I look back say to the late 1970's and say it used to be 18 percent private investment owned by Americans, and it's now around 14 percent or 14.5 percent. We would like to get it up by 3.5 percentage points of GNP, and then I would like to reduce the deficit by 3.5 percentage points of GNP, and that soon gets me into surpluses, but I don't think that's a dirty word.

But I would go through some such arithmetic. You may not, or the Congress or the country may not, share my view about how big investment ought to be, but I have come to the conclusion that that is a decision that the Government is profoundly influencing and it ought to have a position about it.

Ms. RIVLIN. I would agree with all of that, but add one more focus. In deciding how much investment we need, I think one has to look forward as well as back, and one of the significant things about the next 20 years is we are going to have fewer workers in relation to the total population. That suggests to me that we need more investment and not less to make those workers more productive. That higher standard suggests an additional reason for moving from deficit to surplus.

Mr. GRAMLEY. If I could add just one more point, and I agree with everything that has been said so far, and that point would be that we have somehow managed to talk ourselves into the view that increased taxes are bound to reduce our national growth rate. That is certainly not true.

Higher taxes in some respects could increase our growth rate. We could improve our national saving and add to capital formation, with a tax, for example, on energy, and it would have beneficial effects on energy consumption also. I think we just are not facing realistically the kind of choices that we as a nation have.

Representative OBEY. Thank you, Mr. Chairman.

Representative HAMILTON. Congressman Scheuer, do you have anything further?

Representative SCHEUER. I would suggest to you, Mr. Gramley, to put a little footnote on your suggested tax on energy, Time magazine in its January issue on planet of the year, urged that we have a 50-cent-per-gallon tax on gas, and Time made the point that, first, it would raise $50 billion more and would go a long way to balancing the budget and, second of all, it would make manufacturers begin to think about producing more fuel efficient cars in this country and spending the $3, $4, or $5 billion that needs to be done to do that.

In Europe and Japan there are three or four different companies that have cars, prototype cars that go 100 to 120 miles per gallon of gas, but that can only happen when fuel is precious and scarce and expensive. Where fuel is cheap, it's used in a profligate way and it

wouldn't pay for the manufacturers to invest in that magnitude of research and development funds because consumers wouldn't pay for it while gas is that cheap.

Now that was a very interesting suggestion of Time magazine's, but yet it disappeared without a trace, and nobody wants to talk about that kind of thing.

I guess, as Mr. Stein indicated, there is a widespread fear that the public won't take it, and maybe on that particular subject where we have a love affair going with the internal combustion machine maybe there would be widespread unhappiness about a major increase in the tax on gas.

Then we get back to the folks that Mr. Stein mentioned, the folks that get elected on a 2-year basis or a 4-year basis or the 6-year basis, which includes all the decisionmakers around here. Do they have the toughness of spirit to urge these kinds of public actions that are in the long-term public interest, no question about it, where it involves a degree of belt tightening.

Mr. STEIN. Well, I had an interesting experience. I came here in a taxi, and the taxi driver asked me first was I a Congressman, and I said I wasn't, but that I was going to testify. He said, are you going to talk about the homeless? And first I said, no, and then I said well, in a way indirectly I am because I'm going to say we should have more taxes in order to pay for a lot of problems, including poverty, the homeless, and so on. He said, "Oh, no taxes." He didn't want any more taxes. He just wants us to stop the Government from stealing all that money at HUD and Defense and so on, but no taxes. So there you are and there is the public voice.

Representative HAMILTON. That's the absolute heart of it, Mr. Stein, and a politician faces that every weekend when he goes back for a public meeting.

It seems to me that I hear all of you saying that what we need to do now is collect more taxes and spend more in the public sector, and that we have been emphasizing too much consumption and what we do with the taxes we collect.

Am I hearing you all about the same way on the specific question of taxes?

Mr. STEIN. Well, I certainly think we need to collect more taxes. I would not want to increase public expenditures generally without discrimination. I think there are a lot of public purposes for which we need to spend more money.

Ms. RIVLIN. I think many of the public purposes, however, are the domain of State and local governments, and I am as concerned about how to get more resources for State and local governments as I am about the problem of the Federal Government.

Representative HAMILTON. Mr. Gramley.

Mr. GRAMLEY. Well, I would agree generally with your statement, Mr. Chairman, but it isn't just a question of whether we need more taxes. The political process has not been able to solve this deficit problem without looking seriously at taxes, and by default, therefore, that issue is what we have to face next. We are failing to do an awful lot of things that are terribly, terribly important simply because we don't want to face this difficult choice.

Representative HAMILTON. OK. Any other questions for the panel here? [No response.]

Thank you very much for your testimony this morning. It was a good discussion, good testimony, and we appreciate your presence.

The Joint Economic Committee stands adjourned.

[Whereupon, at 11:05 a.m., the committee adjourned, subject to the call of the Chair.]

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