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ROUNDTABLE CONVERSATIONS ON THE STATE OF THE ECONOMY AND ECONOMIC POLICY

HEARINGS

BEFORE THE

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CONGRESS OF THE UNITED STATES

ONE HUNDRED SECOND CONGRESS

FIRST SESSION

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ROUNDTABLE CONVERSATION WITH PAUL SAMUELSON ON THE STATE OF THE ECONOMY AND ECONOMIC POLICY

THURSDAY, JULY 11, 1991

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

The Committee met, pursuant to notice, at 10:00 a.m., in room 2359, Rayburn House Office Building, Honorable Lee H. Hamilton (vice chairman of the Committee) presiding.

Present: Representatives Hamilton and Armey.

Also present: Chad Stone, professional staff member.

OPENING STATEMENT OF REPRESENTATIVE HAMILTON, VICE CHAIRMAN

Representative HAMILTON. Today is the first of several roundtable conversations that the Joint Economic Committee will be holding with prominent economists to discuss the state of the economy and economic policy.

We are especially pleased to have as our first guest Paul A. Samuelson, Institute Professor Emeritus, Gordon Y. Billard Fellow, Massachusetts Institute of Technology.

Professor Samuelson, of course, needs no introduction at all. His name is synonymous with economics for a large number of people whose first exposure to economics was through his textbook.

We're very pleased indeed to welcome you, Professor Samuelson, and we look forward to having a good, stimulating, and enlightening conversation with you.

I see you have prepared a statement. The prepared statement, of course, will be entered into the record in full and, though we really want to emphasize the conversational part of this day, we'll let you begin with whatever comments you think appropriate. And then we'll turn to the dialogue.

Representative ARMEY. I'd like to make a few comments.

Representative HAMILTON. Certainly.

Representative ARMEY. Professor Samuelson, I'd like to welcome you too. And, Congressman Hamilton, I would say, as a student of economics, I had the privilege of having my first exposure to economics to Mr. Samuelson's "Principles" book. And, after several years of studying economics, I finally reached the point where I was able to read and comprehend at least significant portions of the "Foundations of Economic Analysis." The two books must never be confused.

Today, I had the high privilege of having Professor Samuelson autograph this copy of the "Foundations" for me. I want to thank you and welcome you here today.

Representative HAMILTON. That's not the textbook then?

Representative ARMEY. No, this is the task book. [Laughter.]

Representative HAMILTON. All right, Professor Samuelson. You may begin.

STATEMENT OF PAUL A. SAMUELSON, INSTITUTE PROFESSOR EMERITUS, MASSACHUSETTS INSTITUTE OF TECHNOLOGY

Dr. SAMUELSON. Well, let me begin by mentioning that the U.S. economy still does enjoy the highest average real per capita income in the world. If you do the computation correctly and call America 100, Canada would come next at around 95; then Norway, enjoying North Sea oil, weighs in at around 90. And in the highs 80s, about seven-eighths of our standard of living, you find West Germany, Switzerland, France, and Denmark. Japan, whom we often envy, would actually show only about 75 to 80 on this scale. I'm emphasizing that because this computation is often done wrong in any week that the American dollar goes down. The people who do it wrong suddenly mark down our relative living standards. That really won't stand up to careful analysis.

We are still growing. But we are not growing at the rate that we grew in the decades of the 50s and 60s. If you use per capita disposable real income—what we have to spend after taxes—our growth rate was about a third in each of the decades of the 1950s and 1960s. And then, sometime around the OPEC shock when the price of oil went up fivefold—but I don't think you can attribute it simply to the price of oil—growth rates all over the world dropped dramatically with no exceptions. This includes Japan and others. Our growth rate, using that previous measure, dropped to about one-fifth. And in the long-business cycle expansion of the 1980s, our growth rate by that measure was something less than one-fifth. So, if we mechanically extrapolate to the 1990s, the last lap of the decade, we can hope to show positive growth but perhaps at a reduced rate of one-sixth or one-seventh. It could even be below that depending on how you in Congress do your jobs.

Other leading countries have been reducing their gap behind us. And, if we're talking about the end of the decade, they may overtake, in some favorable cases or even surpass, our average living standards.

Why this apparent slowing down—and by the way, the slowing-down I talked about would be much sharper if you used, as your alternative measure, median-family-real income. I did better than my parents. Our parents in American life were accustomed to doing better than their parents. I'm afraid many of today's children do not do better in their generation than mine.

We think of Yuppies. But the typical Yuppie family often is two people working very hard and just about being able to match the standard of living that their parents had. If we dig deep into this, we find that much of it—maybe most of it—has little to do with Washington, D.C. and inside the Beltway. It's something deep in economic law. But there is a part of it—and that's the part, I daresay, you'll want to address—that is associated with what happens here with what policies are followed. So, if I may, I'll just mention some of these deep, long-run trends.

As a nation becomes affluent, its productivity growth does seem prone to decelerate. It's tough to be the first bicycle rider in the race. It's a little bit easier to be the second rider behind that fellow and ride on the slipstream of the leader. So it's understandable how, in the great half century almost after World War II, the rest of the world has been able to lower the gap between them and us as the leader.

I have to warn you that it's very tough to know how to measure services in the modern economy accurately. And, increasingly, services are important. So, there could be some spurious element of pessimism in these numbers. But I think after you allow as best we can, we have to realize that we are a very affluent nation. It's natural when you're affluent not to work 12 hours a day as our great-grandparents did, taking time off at the work bench for breakfast in those days. Taking it easy does show in the figures, and it should. This is a proper way of spending some of our affluence.

Beyond technological productivity trends—what Isaac Newton, Einstein, and Edison gave us—a second basic cause of growth retardation comes from any shortfall of capital formation. I'm talking here about basic supply-side economics. I'm not talking about any particular version of early 1980s supply-side economics.

Capital formation, as economists can measure it—plant, equipment, human capital in the form of education—are important components of growth. And, to a point, an affluent and slowly growing society tends to be less thrifty at the private level, at the level of families, and at the level of corporations—this is aside from Washington, D.C.; this is just the national tendency.

I have a colleague, Professor Franco Modigliani, who has, I think, the best single theory of savings. It won him the Nobel Award. He can

explain why, when population is growing less rapidly and when productivity is growing less rapidly, the saving rate would tend to go down.

A low domestic saving rate must insidiously undermine future growth. It will slow down the rise in productivity earnings unless foreign savings can be tapped or borrowed by America—something new in American life—a debtor nation.

Well, as can be discussed if you want to, government policy cannot do an awful lot to affect private saving propensities.

During the Great Depression we were told on radio, not TV, to go out and spend more money. The Japanese Prime Minister Nakasone didn't say, go out and invite a sailor to a cocktail party. He said, go out and buy some American goods and help the balance of payments. That kind of talk is easy, but it doesn't really show up in the statistics.

However, there is one new factor in American life. It's something that you didn't study at the University of Oklahoma and wasn't in the older editions of the textbooks, namely, a new kind of budget deficit—a long-term structural deficit.

I've testified a lot before this Committee and many committees on deficits. Many times I've come in in favor of cyclical Keynesian deficits. And for me to shed crocodile tears about any deficit would be a joke.

But the structural deficit that I'm now speaking of is the deficit that is there and is designed to be there at full employment. When we were at only 5 percent unemployment, it was very hard to stretch out any increase in the American labor force. We were having very large deficits measured in the only metric that makes sense, because who can say what $10 billion dollars is or what $100 billion is. But as a percentage of another large number—the GNP—we're talking about structural deficits of 2, 3, or 4 percent.

Just to orient us, when I was one of President-elect Kennedy's economic advisors, we were working very hard to get a $12 billion deficit, the largest number that Eisenhower ever had and one we thought the political traffic would bear. Of course, it was a smaller economy then, and the price level was lower. But when you work out what that was as a percentage of the GNP— and it was a recession deficit—it came to only half a percent of GNP, in comparison with what we are now faced with.

I won't bore you with the social accountancy and the taxonomy of GNP. But a nation's saving rate is what its families save, what its corporations save, and what its public sectors save. And if you add public sector dissaving, which is what the structural deficit is, to the other two, only then do you get the overall saving rate. And this is, of course, something that the electorate does have some control over.

If this sea change in American life toward lower saving reflected some groundswell of changed opinion in the mainstream; if sometime around 1980 we all met in town meetings—New England town meetings in my case—and said, well, we're now very affluent. Now, we don't want to grow as fast in the future as before. We understand the costs, and we

don't mind selling off some of the farm to foreigners—our shopping malls and buildings. After all, for the cost of one Tokyo skyscraper, you can buy three New York skyscrapers. Suppose this is the way we want do things? Then who am I, a professional economist, to second-guess the wisdom of the American people. But I don't perceive it happened that way at all. We elected what seemed to be the most conservative President in 50 years, in what was probably the second most important election of the century. And the consequence in the following period was a massive shift—a sea change—to a different kind of public finance and one which, by all previous standards, would have been considered the opposite of conservative economics.

I don't know whether at any stage you want to speculate on what some of the factors were that were responsible for that. But I want to point out that this structural deficit is under the control of the electorate and the electorate's representatives in the White House and in Congress. The main way that a responsible Congress could increase the overall saving rate of the American people would be by reducing the negative public- sector saving. How can that be done, I used to be asked—and I was always reminded, I think it was of Senator Aiken who was asked, how can we get out of Viet Nam. And he would answer, "I think in ships." [Laughter.] You have to cut a structural deficit by raising tax revenues or cutting expenditures. And, to a first approximation, economic science—and I have a little curl in my lip when I use those words—is neutral on whether you do it the one way or the other. To a first approximation—as far as the mechanics of contriving capital formation and raising the saving rate is concerned—if you're going to go part way of the tax route, it is not fundamental whether you do it by so-called progressive income taxation, or by a value-added tax, or by excise taxes.

Of course it's been said that God is in the details. The only difference between a Stradivarius and a ten dollar violin is the overtones. And so, to the further approximation, human values and equity are involved.

Well, you may remember that I said that a reduction in the saving rate of the nation—looking ahead—is going to mean a reduction in its capital formation and a reduction in its productivity earnings trend of growth. All this I said would happen to a nation unless it taps foreign savings. That's how we came to have two deficits. Both of which are new to my textbook and unpredicted by any of the experts in 1979 or 1980. We came to have not only the structural budget deficit but also the balance-of-payments chronic deficit.

If you plot, as any textbook writer might, the exports and imports before 1980, they hug each other very closely. And the difference very closely hugs to zero. There's only a weak trend if you're very clever and can discern it.

Suddenly, after 1980, you see big and precipitous discrepancies. I don't think these two trends I'm talking about are independent. Because it's in accordance with economic law that if one huge region of the world that

is greatly reducing its saving rate, both on private account and on public sector account, while other parts of the world—the Pacific Basin, and that's more than Japan and the Common Market—have a higher saving rate, then it is natural for the low-saving country to begin to incur a balance-of-payments deficit and to be selling out its assets. I was going to say patrimony, but I thought that might be sexist; matrimony can't be quite right—whatever the appropriate word is.

I want to emphasize that it is important to experience level playing fields, and it is important for France and Japan to undertake fair trade as part of free trade. But even if they came into court with clean hands and did that, you would still have left a very important part of the balance-of-payments problem as long as we continue to run the railroad the way that we have.

Indeed, suppose the foreign people in Japan, Holland, Britain, and West Germany had been unwilling to recycle back their surpluses—our deficits are their surpluses if they were unwilling to recycle those back in American investments—Iowa farmlands, branch plants here, purchase of our public debt—then the resources, which we have available for capital formation and which have held up very well considering the dire scenario I have painted for you, held up because we are still planting trees of capital. But on those trees, it is clearly marked: Not owned by Americans; owned by foreigners. When the nuts and fruits of those trees become available in a regime of contract and due process, they will become available for the foreign owners. Now I don't like all this, but I would like it less if we didn't have recycled deficits. Because for a typical wage-earner in American in 1999—when I say wage-earner, don't just think of a blue-collar worker, think of a professor or whatever of God's creatures you're interested in—it doesn't matter where the capital goods came from. If that wage-earner has more capital to work with, the chances are the 1991 productivity wage is going to be higher whether that capital was provided out of good and honest local domestic thrift or whether it came from abroad.

I should also say that if there was no willingness abroad to recycle those savings, we would not continue to have a chronic deficit. What would happen is the dollar would have to be bid down. And it would have to be bid down enough that our goods would be so cheapened in the competition for foreign trade as to let us balance our books at that lower level. Let me bring this to a close. What does it all mean for public policy?

First, it means that no clever capers by the Volcker or Greenspan Federal Reserve can contrive low enough real interest rates to offset the insufficiency of domestic savings under present fiscal policies. The Federal Reserve can do its job extremely well, or a little bit badly, but it can't set the level of the ocean. Easy budget deficits entail hard and austere monetary policies whenever full employment prevails. That is point number one.

Point number two, before 1980, Americans could fight recessions with stimulative monetary policy—that means primarily by the Federal Reserve—and also with temporary fiscal stimulus. But now cyclical stabilization has had to be flying on one wing only—the wing of Federal Reserve policy.

Or, take a third problem. Maybe this is too divisive, but let me just mention it. We have the proposal by Senator Moynihan to reduce the Social Security payroll tax. How is such a proposition affected by this fundamental diagnosis? It could be crucial. When back in 1937—really back in 1935—America elected to finance most of Social Security on a pay-as-you-go basis, that was a very fundamental decision. We backed into it; we didn't think a lot about it. And, of course, it was not a time when saving was popular. But there were some people who said that we ought to have done it on an actuarially-sound basis. Now that decision, made then and adhered to since—we at times have goosed up the payroll tax rate and got a little extra liquidity in the trust fund—but if you always carry in your mind, next to the actual trust funds, what the actuary would require on an actuarially-sound basis, so that during our working lives we put aside—in the planting of trees that would later bear fruits and nuts—enough to pay our retirement incomes, that sum would be colossally bigger than anything we would be talking about. I had to use very large type to write colossally on the typewriter. So we're very far short of that. Now, my point here is not to fight that old battle, and say we should have done it the other way. But the Robin Hood proposal that would seize some liquidity on the books, even though that liquidity is very short of anything corresponding to the capital formation needed actuarially, and to want to tap that would be essentially increasing—this is just a matter of social accountancy—what is already a significant level of public-sector dissaving.

I'm not passing any judgment on the Moynihan proposal, because all you would need would be 51 Moynihans in the Senate to offset the tax rebate by some kind of Robin Hood proposal of taxing the rich to make up the difference. I don't even disagree that it's somewhat regressive for me to be paying payroll tax only on the first $50,000 or $60,000. However, if Professor Moynihan, or Dr. Moynihan, or Senator Moynihan and I sat down and compared how regressive the Social Security tax is to a person of my income tax—taking into account both expenditures and payroll—I think it might appear in a different way.

Well, we're probably coming out of a recession. We have a new Federal Reserve Chairman reappointed. There are many issues that bear upon the fundamental backgrounds that I've been talking about. And there are many issues of market incentives that could properly enter into the grand debate about these matters.

I'm prepared to try to answer any questions you might put to me.

[The prepared statement of Dr. Samuelson follows:]

PREPARED STATEMENT OF PAUL A. SAMUELSON

If we make the computations correctly, the United States economy enjoys the highest average real per capita income in the world. If we call America 100, Canada comes next at around 95; then Norway (with North Sea oil) at around 90; then in the high 80's West Germany, Switzerland, France, and Denmark; Japan would still show only about 75-80 on this scale.

America grew in per capita disposable real income about one-third in each of the decades of the Fifties and Sixties. Our growth rate stayed positive in the Seventies and the Eighties; but, as with retardation in other leading nations, after the supply shock of OPEC, our 1970s' growth rate dropped to one-fifth; and in the long expansion of the 1980s, our growth was something less than one-fifth. If we mechanically extrapolate to the 1990s, the century's last decade will show positive growth but perhaps at the reduced rate of one-sixth or one-seventh. And other leading countries may well reduce their gap behind us, or even in some favorable cases may overtake or surpass our average living standards.

Why this apparent slowing down of growth in American living standards, which would appear even starker in the Seventies and Eighties if we used as our measure median family real incomes?

1. Productivity growth of an affluent nation seems prone to decelerate--although admittedly measurement of productivity growth in services is difficult and some resulting bias may spuriously lower the statistical estimates.

2. Beyond technological productivity trends, a second basic cause of growth retardation would come from any shortfall of capital formation--of plant and equipment plus human capital in the form of worker education. An affluent and slowly growing society tends to be less thrifty at the private level of families and corporations. A low domestic saving rate must insidiously undermine future growth

and slow down the rise in productivity earnings--unless foreign savings can be borrowed by America as a debtor nation.

3. As will be discussed, government policy cannot much affect private saving propensities. However, the new factor in American life--the long-term structural budget deficit that now prevails at both high and low employment--superimposes on low private thrift negative public-sector savings. Fiscal policy can affect the nation's overall saving rate--either by raising tax rates and revenues, or by cutting expenditures, or by some combination of tax rise and expenditure reduction. To a first approximation, economic science is neutral on how a dollar reduction in budget deficit is contrived; and, to a first approximation, it does not matter where the tax increase comes--from income tax on affluent or middle class or from value-added or excise taxation.

4. Before Reaganomics there was already some trend toward a lowered American saving rate. Following political victory of 1981 so-called Supply-side Economics, the transformation of America from the world's largest creditor nation to becoming a debtor nation vastly accelerated. Before 1981 and the new structural budget deficits, our trade almost was in balance. Without prior warning, suddenly chronic balance-of-payments deficits on current account exploded.

All this was in accordance with economic law not contrary to it. Even if Japan and the Pacific Basin, along with Germany and the Common Market, had presented us with "level playing fields" and "fair trade", America's lower saving rates than theirs would militate toward using up our patrimony of past foreign investments and their acquiring a surplus of our buildings, shopping malls, office buildings and hotels, portfolio securities and American public debt, and branch plants on our soil.

Indeed, had foreigners been unwilling to recycle their trade surpluses back here in such investings

1. High consuming by Americans and their governments would usurp resources needed for capital formation, thereby "crowding out" investment here and lowering the future productivity earnings of our labor force who work with machines and other capital goods. The indicated drop in the Nineties' growth rate would be intensified, possibly even to the point of a trend decline in American living standards.

2. The trade deficit itself could not continue if it could not be financed on capital account out of foreigners' savings. The dollar would have to plummet downward relative to the yen, mark, and other foreign currencies. Resources now kept available to domestic capital formation in America would then be having to go into export production to pay for our consumption splurge on imported goods.

The protectionists' dream would be partially realized without tariffs or quotas--as unwillingness of foreigners to recycle and invest were to take over. Alas, the free trader's nightmare would also be realized.

> Opting out of the efficient and productive international division of labor, a more self-sufficient America would risk a drop in its living standards as our average productivity is lowered by our applying resources where we lack comparative advantage.

What It All Means For Public Policy

1. No clever capers by a Volcker or Greenspan Federal Reserve can contrive low enough real interest rates to offset the insufficiency of domestic savings under present fiscal policies.

> Easy budget deficits entail hard and austere monetary policies whenever full employment prevails.

2. Before 1980 America could fight recessions with stimulative monetary policy and temporary fiscal stimulus. Now cyclical stabilization flies on one wing only--the wing of Federal Reserve policy.

3. How one appraises Senator Moynihan's proposal to reduce social security payroll taxes is critically affected by this diagnosis. Let's see why.

A. When America elected to finance most of social security on a pay-as-you-go rather than on an-actuarially-sound basis, that contributed to the 1937-1991 drop in private saving ratios. Our base old-age retirement income comes to us without our sacrificing through payroll taxes prime-of-life consumption at the actuarial level needed to provide for the retirement years.

B. The fact that Trust Funds grow a bit conceals the above truth. Actuaries would require that they grow COLOSSALLY, and their shortfall from that par vastly exceeds the accumulated amount that Dr. Moynihan covets on behalf of the masses. His Robin Hood proposal would, to the objective social accountant, somewhat increase what is already a significant level of public-sector dissaving!

(None of the above denies that present payroll tax rates, divorced from the benefits formulas "progressive" by income class, taken by themselves are "regressive." Economic science recognizes that a fiscal benefit to the poor that augments public-sector dissaving could be offset by new tax increases on the middle- and high-income classes, but it would take 51 Moynihans in the Senate to pull off that hat trick!)

1991 Recession and Recovery

The Greenspan Fed acted well to keep the 1987 Wall Street Crash from snowballing into depression or even into recession. Fearful of a reacceleration of inflation, and feeling constrained by high real interest rates in Germany and Japan, the Fed has only cautiously eased short-term interest rates in 1989-1991 in order to

a) forestall a recession, b) moderate the post-July '91 recession in being. Their caution contrasts with Paul Volcker's well-timed boldness in mid-1982 that reversed the 1981-82 Recession and led to almost eight years of recovery.

It is Congress that must decide whether the prime goal of monetary policy is to be "Zero or Negligible American Inflation by 1995 or Shortly Thereafter." If that is the Electorate's Will, the Congress must be prepared to tolerate in 1991-1995 (a) unemployment rates that stay above 6 per cent; (b) either a continuance of a mild recession or toleration of a weak recovery.

No traditional theory of democracy, or post-1913 separation of powers between the White House, Congress, and the Federal Reserve, gives three or four members of the 18-person panel of Open Market Committee members the autonomous power to impose on the American people slow or negative growth for half a decade. If society decides that an extra million Americans will have to be without jobs in the 1991-1995 years, as a regrettable cost of extirpating inflation, that decision cannot be made by technical economists or appointed Central Bankers but rather must be affirmed and reaffirmed by the Electorate's representatives. The American system of separation of powers between an independent Federal Reserve System and the Legislative Branch presupposes oversight and vigilance on the part of the relevant Congressional committees.

Fortunately there have not thus far in the present stages of the business cycle been grave current sacrifices at the alter of long-run inflation control. But that has been precisely because the more hawkish of the inflation fighters have been in the minority and have been whipped into moderation by the pressures of the majority. Eternal vigilance remains the price of optimality. Complacency about the likely weakness of the 1992 Recovery could constitute an insidious danger, just as [illegible] back in 1930 when a run-of-the-mill recession was permitted to snowball into a great depression and collapse of the uninsured banking system.

Fine tuning is an impossibility--a truth no less applicable to inflation bashers than to over-full-employment zealots.

Market Incentives

Market incentives are important, as the collapse of Eastern European communism has dramatized. However, the 1981 dogma of Stockman, Laffer, and Kemp--that 1980 was a Dunkirk for the U.S. economy and that reducing regulations on business and lowering tax-rate wedges between before-tax and after-tax returns would initiate a great sprint forward in American productivity--all this was doctrine not squaring with the facts of economic history or the attested principles of economic science. Both conservative and liberal economists testified to this effect in 1981.

And so it turned out. America's saving propensity did not get stronger: already weak, it got weaker. Productivity trends did not accelerate: they continued to be weak and weaker, until the goad of competitive imports finally began to induce some improvements in our manufacturing productivity.

The weight of evidence suggests that a Mixed Economy--when, like Sweden and Israel or the Netherlands, it begins to pass through the tax-and-spend system half or more of GNP and to impose 60%-or-more marginal tax rates on median income classes--will begin to show some of the signs of inefficiency and productivity stagnation found in the command economies of the socialist bureaucracies.

America is not there. We are not, by objective fiscal tests, at the limits of taxability. Nor were we in 1980 or 1970. Actually, when top marginal tax rates were twice what they are now, America did grow faster than we grew in the 1980s. The nations we envy for their rates of economic progress--West Germany, Japan, Switzerland,...--do not possess lower tax rates than we do today in America. (Nor are their regulations effectively less.)

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Attempts to legislate specially low tax rates targeted to stimulate particular lines of activity--venture capital, equipment spending, and so forth--very much need to be justified. Many of the excesses in the field of real estate, oil drilling, and timber cultivation are traceable to the sweetheart deals legislated. Better it is for an economy to have the general interest rate charged to all for capital formations be as low as the society's savings permits, than to incur the deadweight losses associated with investment tax credits and the like. A good growth program will allow for low capital-gains tax rates on those capital gains which reflect merely the rise in the price level associated with general inflation. That allowed for, the economic case is strong to tax all incomes alike and with fair offsets for losses.

I should be glad to respond to questions on these incentive issues, and indeed to any questions of interest to the Committee.

Representative HAMILTON. Thank you for that good beginning, Professor Samuelson. We'll open up with questions. I'll pick up where you left off. You indicated that we're coming out of a recession. Could you give us a very quick critique of what you think we ought to be doing right now with respect to economic policy in the country? We're coming out of a recession, as you said. What ought we to do in the Congress; and what ought the President to do on the fiscal side; what should the monetary authorities do?

Dr. SAMUELSON. I'm now going to give my personal reading of the evidence, and I'll try to do justice to different sides of the matter.

The Federal Reserve, under Dr. Greenspan did, I think, a superlative job at the time of the stock market crash in 1987. That crash, in its statistical magnitude, properly reckoned, was quite comparable to the October 1929 crash. It was a vulgar belief in the part of Indiana that I grew up in, that the stock market crash was what caused the Great Depression. I think modern economists regard it as the overture to a tragic symphony but by no means the whole story.

The fact that all the banks in my part of the country—I can say all but you could point out exceptions—failed, I think, was the more important part. You had to buy change at one time there.

Now I don't think that mankind is a lot smarter in 1987 than it was in 1929. This worldwide collapse in stocks was speeded up a little bit by the modern computers so that you could do in 30 minutes what used to take a day and a half. If that had happened in a completely laissez-faire, pure capitalism system of the kind I grew up under—I sold *Saturday Evening Posts*—I could have been President; I don't know why I wasn't. [Laughter.] But the old system was where the Government had no real responsibilities. And today, if we had the same kind of system, we could have had—built up over many long periods of accumulation—some comparable problems.

The difference essentially was the insurance system of the banks. When one bank failed in the old days, we all ran to any bank—the good banks, the bad banks—to take our money out, and we were right to do that. Because if we didn't get it out, we often got 2 cents on the dollar.

Now a bank fails and, generally speaking, nobody suffers. It just gets added to the backlog of the public debt. That seems a great and wonderful thing. It is a thing, however, with grave future consequences. Because if we deregulate a system where we are underwriting these losses by insurance, we are creating a heads-I-win, tails-the-Government-loses situation for every rash banker to take whatever chances seem desirable—like an old-time bank teller who has tapped the till and goes to the races in a desperate hope to win it back. Well, it's our money that is being played with.

The Federal Reserve 1987 telephone call from Greenspan on Monday and Tuesday—we don't know all the details—handled that crisis very well. They gambled by the traditional economist's advice, which is you

flood the market with liquidity or a promise of liquidity, knowing you'll take in the sail later. And if you promise it, you don't have to use it. So, I give that Federal Reserve high marks—A plus. I give Paul Volcker high marks in acting to end the 1982 recession, which I had testified before Congress—for what that's worth—was going to end on my birthday, May 15, and it didn't. And in the middle of the year, Paul Volcker, a conservative central banker, saw a window of opportunity to turn us around with minimal inflation risk. What he did was to act very vigorously, and the money markets here and abroad responded favorably.

I don't think that Dr. Greenspan, as we moved into 1989—we were at the end of a very long expansion period—had quite the elbow room that Paul Volcker sensed he had and grasped. But since 1988, the Federal Reserve has been a little bit late and niggardly in the prudent behavior that one might hope for them. I'm not thinking about finetuning because nobody can do perfect fine-tuning. And I want to state, in their defense, two reasons. One, there was concern that inflation was somewhat accelerating and might further accelerate. Inflation concern is a proper concern of the Federal Reserve, but I don't think it should be the sole, or primary, or only concern. And second, abroad, Japan and West Germany were raising their long-term interest rates. This is very much a one-world so that the Federal Reserve can directly control short-term interest rates; but the market controls a good deal of the longer term, and the steepness of the yield curve can change.

Dr. Greenspan—whom I regard, by the way, as a very savvy economist—I think, is a very conservative economist, and I'm not that conservative. But I think he's very well-informed. I think he became very Delphic in talking to the money market; they couldn't understand what he was saying. Maybe that was his purpose but that was not a good purpose at that time. And, furthermore, he kept telling the market: "You were the ones who set these yield-curve differentials." He had limited powers, and he was further undermining his own powers in the way that the situation was handled. Also, he had a minority in the Fed to contend with. At least three of the 18 members of the Open Market Panel take, as the primary desideratum of the Federal Reserve, a stable price level by 1995.

Representative HAMILTON. Professor Samuelson, are you suggesting that had the Fed loosened up a little in this period prior to the recession beginning, which was July 1990, that we could have avoided the recession?

Dr. SAMUELSON. I think that given the Gulf War, which, of course, we could not foresee in July, we probably would have had a recession anyway. The recession, as dated by the National Bureau, came before the Gulf War. I think that the pattern of it could have been slightly alleviated. But I really want to turn to the present situation.

Representative HAMILTON. Yes.

Dr. SAMUELSON. There is a well-founded belief that probably the recession is over. We won't know that—you have to predict the present

in economics because that's how backward we are. But probably 6 months from now the National Bureau will declare that the bottom was hit in May.

The current orthodoxy—I just checked the *Blue Chip* indicators of 51 consensus forecasters, and most of them agree that, yes, we're going to have a recovery; but we're going to have a weaker than normal recovery—2.5 percent or 3 percent annual rate of growth. Whereas, it's typical in the first year or year and a half of recovery to have numbers like 7 or 8 percent, even 10 percent. I am glad we're going to have a recovery. I do not believe in fine-tuning. But I think that anything much less than 4 percent in the very beginning is being a little bit niggardly.

What Paul Volcker did was to overdo it slightly as we came into the fourth quarter of 1982—which was the turning quarter—and he overdid it in the next quarter because he wanted to be really sure it happened. Then, following that, he underdid it.

Now there are monetarists who consider that to be two crimes. You ran a Mack truck over a person and then you backed it up and ran it the other way over the corpse. They score that as two crimes.

Any sailor who goes off on his tack into the wind and then goes off on that tack and averages out about right, I think of as following good procedure. I believe in an independent Federal Reserve. But I believe in it in the Teddy Roosevelt sense. He said, "Walk softly but carry a big stick." An independent Federal Reserve is under the supervision and surveillance of the congressional committees and the White House. Now, you cannot turn the lights off on the Federal Reserve. It has its own budget and electrical supply. But the business of the Federal Reserve is to be responsive to the long-run interests of the electorate and it is subject to the surveillance of the congressional committees. There cannot be 12 wise persons or 18 wise persons, who are set up to be immune to political influence like Platonic philosophers, to run the country. In particular, there is a serious debate going on among economists and in the internal councils of the Federal Reserve. Three or four members of the Federal Reserve would take price stability as the crucial primary goal.

If it is to be public policy that we are to subordinate to the goal of having zero or half a percent inflation by 1995, and if the cost of that objective is either a continued recession or a very slow rise out of that recession, that decision cannot be made autonomously by a group of independent bankers or technical economists. It must have the blessings of the electorate through their representatives in the legislative and executive branches. This is something that is very much in the bailiwick of the proper committees of the Congress and, of course, the Joint Economic Committee.

So I would say that I don't give Dr. Greenspan's Federal Reserve a gentleman's C; I give them a good firm B. But the reason that they have a good firm B is that the minority group has been held in check by what

is still a bare majority on the Federal Reserve. And I would not like to see that equilibrium changed in the other direction.

Representative HAMILTON. At this point, do you think the Fed should loosen?

Dr. Samuelson. I think that everybody in the money market—and you can see this by forward rates—is of the view that they can't expect much more from the Fed with respect to easy money. In an inexact science like economics, I don't think that the certainty of the passable recovery is such that that's quite good enough. Now this is not—I was going to say it's not a federal offense—the biggest thing in the world, but it's part of the picture and could become that.

Representative HAMILTON. One interesting thing about your response. I posed the question: What ought we to do in the economic situation now? And your response was really totally with respect to the monetary side. Therefore, is it correct for me to assume that you really don't think there's much that the President and Congress can do at this point, or should do?

Dr. SAMUELSON. Well——

Representative HAMILTON. You did mention earlier in your remarks about the importance of getting the deficit down as a part of saving.

Dr. SAMUELSON. And I want to go back to that. It's simply because I'm so pessimistic and hopeless about you fellows and the American electorate on the fiscal policy that I don't repeat myself like that Senator in Rome. He said at the end of every speech: "Carthaga delenda est"—Carthage must be destroyed. So, I'll say at the beginning that this structural deficit would be on my wish list for destruction if only we could make some progress out of the political impasse. By the way, the political impasse that I'm talking about on why we are not able to do anything about the deficit is not simply a Washington impasse; it's a mainstream impasse.

We've all learned to like the sweetness of low tax rates. And we all continue to insist upon honoring contracts to our older citizens, wanting our military properly armed in the Mideast and elsewhere, and wanting to meet the medical research needs of the Nation.

Just to go back to this, we are not an overtaxed nation by any objective economic standards. Considering our propensity to spend publicly, we are an undertaxing, overspending nation on a consumption spree and have been for a decade. It's our new normal way of life.

Representative HAMILTON. Professor Samuelson, I want to interrupt you here and turn this over to Congressman Armey, if he would please. We have a vote in the Democratic caucus. You probably read about that. It'll take me 10 or 15 minutes to do that, and I apologize for the interruption here.

Representative ARMEY. Professor Samuelson, as I recall, I mentioned to you earlier that I lost this 16 pages of the "Foundations;" I will reclaim that by an act of piracy from the Library of Congress. But I remember the

preface was such a great discussion about the importance of methodology. It's one of the finest discussions of methodology that I have ever read. And I'd like to talk in terms of methodology for a moment if I could.

I should point out that I'm what's known in our trade as a Stiglerite or a Freidmaniac; I'm not a monetarist. Probably in a little more common parlance, I have a healthy suspicion, perhaps even disdain, for macroeconomics and an intellectual devotion to microeconomics. And you have had a distinguished career on both sides of that spectrum.

But, if I can, I want to get to the question of the methodologies we employ in the decision-making processes here in Washington, evaluating alternative policy analysis. But I'd like to make the observation that as I see the practice of political economics in a macroeconomic sense, I am reminded that the psychologist defines the cause of frustration as trying to control the uncontrollable. And it seems to me that macroeconomics is by and large designed for the economics of control and generally ends up in a lot of frustration. Microeconomics, on the other hand, is the basis by which we try to properly acknowledge and predict the response of those who will be affected by policy options. I don't know how familiar you are with our methods of scoring policy analysis used by the Joint Tax Committee, the Congressional Budget Office, and other organizations; but we have a very static methodological approach to this where we simply do not acknowledge the response. I can give you one quick example. In this whole controversy that we have about whether or not we ought to repeal or at least lift the trigger on the earnings limitation for senior citizens, our analysis of that is limited only to the direct outlay of expenditures on seniors and does not acknowledge the tax revenues that would come from more seniors working longer hours and, perhaps, at better pay. It seems to me that that becomes a very incomplete way of analyzing. I wonder if you have had an opportunity to study any of these methods and have any reaction to it?

Dr. SAMUELSON. Well, yes indeed. Just to take your specific example, because of the indiscretions of my generation—and I'm referring to my six children—we have a Baby Boom generation. That Baby Boom generation is moving into their 40s now. When they reach retirement age, and if we adhere to what has become common practice—when I was 65 years old and still working, I belonged a minority in American life—and if that swollen generation is encouraged by the pension schemes of corporate and governmental social security to quit work at that early stage, it means that the much reduced population of the cohort succeeding them must, out of their working lives, support the retirement needs of the numerous Baby Boom generation.

Now it's one thing to have slavery and force somebody to work longer, but it's another thing to get rid of bad systems that bribe you to retire early and penalize you for not retiring early. So, I think that under due process, we should be legislating ahead gradual increases of what is considered the normal retirement age at which certain precipitous changes

in the formulas become operative, so that there will be a greater responsiveness to the actual human needs of the future generations as those generations themselves would interpret them. Any methodology that kept that from happening I would be very much against.

Representative ARMEY. I always like to draw the analogy that if you hired me as your marketing specialist and you said, I want you to predict what will be the impact on sales revenue if we raise the price but ignore any change in behavior of my customers, then that would be rather shallow. And that's the analogy I made. I'm very concerned about this. It seems to me that we have deprived ourselves of the best innovations in the discipline of economics through the last 20 or 30 years. And it's a matter of great concern to me.

Since you have distinguished yourself in both micro and macroeconomics, I will not resist the temptation to ask you if you would make a recommendation as to the relative value of the two approaches of the discipline?

Dr. SAMUELSON. Well, I will speak objectively. And I can speak as a participant scholar and also as a textbook writer that macroeconomics was all important in the Great Depression when one out of four people were unemployed, when you didn't transfer a person who lost a job into a new, more effective job but moved them onto the dole. Students were interested in macroeconomics and so were congressional committees. And microeconomics got short shrift.

Well, what comes around goes around, and things have changed. Also, as you say, microeconomics is less controversial. In it there is more chance of agreement. You can't get economists to agree completely on anything, but you've got a little more consensus in the field of microeconomics. But don't ask me to choose between two sweethearts.

[Laughter.]

Representative ARMEY. Good for you.

I want to talk about the structural deficit a moment. It seems to me, if I'm correct in my understanding of what you said, that this structural deficit is really our fundamental cause of the bad savings performance.

Dr. SAMUELSON. It's a worsening of that.

Representative ARMEY. But the structural deficit is in, of course, the federal budget, correct? This is what you're talking about?

Dr. SAMUELSON. Yes.

Representative ARMEY. It seems to me that someplace during the 1960s, my good friend—in fact, I think you might know him—Professor Chen Sun, who is now the President of the National Taiwan University——

Dr. SAMUELSON. I think so.

Representative ARMEY. I know he studied under you.

Dr. SAMUELSON. Right.

Representative ARMEY. But at any rate my good friend, Chen, had made the observation that he had made a rather large contribution to reversing the economic fortunes of Taiwan in the early 1980s. And he was able to do that because in Taiwan they were able to really use fiscal policy, particularly, with respect to decreasing spending. Historically, we have devoted the Federal Government's budget to such things as defense of the Nation and the building of public transportation facilities and the public infrastructure. And that's really, by and large, been the lion's share. But in the 1960s, we, it seems to me, made a fundamental change in the structure of the Federal Government's budget when we developed what are now called the entitlement programs, which are more income redistributional than public or capital acquisitive. And, at least the Director of the Office of Management and Budget says, quite convincingly, that virtually all growth in the federal budget since the mid-1960s has been in this entitlements component. My thesis is that having changed the fundamental structure of the budget, we left ourselves unable to perform the historic task of maintaining our public overhead capital; leaving, as Pat Choate says, America in ruins with its highways, bridges, and so forth in decay. It strikes me that we may have made, at that point, a very fundamental structural decision that has changed the role of the Federal Government from one of creating the conditions for growth and prosperity to accommodating to a philosophy that more or less surrenders to a no-growth belief and focuses its resources on redistribution and, in the process, denies us fiscal policy—in the post-Keynesian sense—as a policy tool. I don't know how you might want to react to that.

Dr. SAMUELSON. Well, let me, with respect, point out one thing. The distinction between having items in the budget that directly use up resources—like the hiring of a postal clerk or the building of a government road—and a transfer payment, which simply collects the money and then disburses it as part of the welfare net of the mixed economy, is a fundamental distinction. And I think you or the Budget Director would be correct to note the slowing trend of exhaustive expenditure on resources the Government uses itself, for example, its arsenals. That component has not grown in the way that the total budget has. But I think we should not confuse that distinction, which is important, with the distinction between the federal, state, and local levels. We've had some very considerable changes in that.

Let me illustrate. Right as we're talking—because it is near the middle of the year—eight or ten states have been in dire budget emergencies and have been furloughing civil servants and so forth. As we are talking, we are still barely coming out of a recession. We have on the books unemployment compensation, and only half the people, or a third of the people who are eligible for that, are actually receiving it. We have emasculated, in practice, one of the automatic stabilizers that used to come into effect. When people were thrown into unemployment, both the human need aspects were alleviated by entitlement to unemployment

compensation, and there is something stabilizing in those transfer expenditures at a time when the economy is short of expenditures.

Because of a withdrawal of the Federal Government in the last dozen years from its previous relationship with the states, the states now lack some revenue sources they used to have for these funcitons; the Federal Government has such revenue sources if it cared to use them, but it has not and it has abdicated many of these stabilizing functions.

Now I don't think economic science, as science, can tell you what is the golden mean between pro-growth policies cum laissez-faire in the marketplace and a network of mutual insurance, so that the people who are treated well in the happenstance of the marketplace, in some measure, are taxed by due process to help those who draw blanks in market life. That involves value judgments, and the electorate has to decide that. I think if you look at the two political parties, perhaps, there is some axis of cleavage between them. Why did God give us two eyes to see? I don't know. But why did God give us the Republican and Democratic Parties? I guess the Republican Party was given to us, by and large, to represent the people a little more affluent than median, and the Democrats have taken on the job of representing the other group. Those conflicts have to be ironed out democratically.

The testimony of economists is important because a lot of the promises made by either side, in fact, are not believable and fulfillable in terms of objective constraints of economic history.

Representative ARMEY. Thank you. Congressman Hamilton, I'm afraid my schedule has caught up with me at this point. I have to go find out why the RTC needs a substantial sum of additional funds. But I can't resist that perhaps God made the Republican Party to see more clearly. [Laughter.] With that, I want to thank you, Professor Samuelson. This has personally been a great privilege and honor, and I thank you.

Representative HAMILTON. Thank you, Congressman Armey, for helping me out here.

Well, I've got a lot of things I want to cover, and I don't want to keep you too long.

To go back to the point we were discussing when I left here, with regard to our most recent experience, it is striking that during a recession we didn't take action to stimulate. I don't think in any other recession, since the end of World War II, that that's been the case. We did not cut taxes. We did not accelerate spending. And we basically stayed within the guidelines of the budget deficit reduction agreement. Was that the right course?

Dr. SAMUELSON. No. In a well-run system, there would have been two wings to our stabilization policy. In a well-run system, we have learned you don't use crash public works programs to solve run-of-the mill ups and downs of recessions, because the time lags involved are such that they don't come on stream fast enough. And when they do come on stream, you may be off to the next fire.

But having said that, I have to say what I had been saying, I think, before you came back into the room. That our automatic stabilizers, which were built up over a period of more than half a century, have been emasculated. Our unemployment compensation system doesn't do the job it used to do and which, uncontroversially, it ought to do.

Representative HAMILTON. And you'd like to see it strengthened?

Dr. SAMUELSON. Yes. For example, part of moving things to the state level and away from the federal level, I have to sadly report, is not a move toward more responsive grass roots or to a more efficient operation, but it is one way of killing lots of programs, particularly when states have to competitively consider what their tax rates are compared to elsewhere. So, we not only have not had, as you say, direct and conscious new fiscal action to affect a recession, we have weakened the automatic fiscal stabilization.

Representative HAMILTON. Inflation today is whatever it is—4 or 5 percent—and I've been in the Congress long enough to remember when we'd get in a state of panic about an inflation rate of that kind. In the Nixon period, the inflation rate, I think, was less than that when we actually put in some kind of controls. Give me your general sense of this inflation. How serious a problem is it, and what ought we to do about it?

Dr. SAMUELSON. Well, I think you're in the ballpark magnitude that a measure of core inflation, smoothing out the ups and downs of the seasonal food prices and oil shocks, is stubbornly 4.5 or 4 percent. Some of the consensus forecasters think we may be moving to just below 4 percent. I would remain agnostic on that question. It seems to be extremely difficult for any mixed economy to really operate at zero inflation or deflation. Japan and Germany come closest, but the countries that link up with the mark in Europe and the Pacific Basin countries do not succeed. So, I think that that is one of the major facts of life that one has to work within. You mustn't, every time the economy moves from 7 percent unemployment to something less, say we're off to hyperinflation. That's not the way the system really seems to work. But you can't be complacent either.

If we were to do what any perfectionist might think reasonable, why should we have to have 5 percent unemployment? Granted some people are going from one job to another, so why don't we work hard and push that down to 4.5, to 4, to 3, to 3.5 percent.

I've been in this business a long time. And I'm afraid that in order to do that, you have to put enough pressure in the boiler so that over time you're going to have an insidious creep not just in the price level but in the rate of its inflation. So, we will need all of the guile of Dr. Greenspan and others to work within this problem.

Representative HAMILTON. Dr. Greenspan has endorsed a bill to hit zero inflation. As you probably know, this has been introduced in the House and maybe in the Senate, as well. If my memory serves me correctly, Dr.

Greenspan testified in support of this bill. Now is that an appropriate legislative target to set?

Dr. SAMUELSON. Well, I think, in fact, it would be a dangerous thing. You know, Congress sometimes late in an afternoon does something for which the Lord will forgive them because they really don't know what they're doing. Congress, as I recall——

Representative HAMILTON. I hope the Lord is as magnanimous as you Professor. [Laughter.]

Dr. SAMUELSON. Well, the Congress once legislated a resolution of the House, maybe both houses, that we should have 27½ million housing starts each year for 10 years. Well, the Lord wasn't listening. Neither was the American economy, and we didn't get it even for 1 year. It's churlish to vote against a resolution like that because it's against the flag, motherhood, and so forth. But if a zealot three-person minority on the Federal Reserve Board was able to say, now look here, the American people—through their chosen representatives—are on record that by 1995 we must banish all inflation, they would really tighten credit. I can assure you that many of those people are not stupid, and they know in their hearts and brains that the only way they're going to get that goal is by having a recession and maybe a serious recession. This has been a light recession so far.

Now if you want to talk business—is that the Neal Amendment?

Representative HAMILTON. It is.

Dr. SAMUELSON. —I'll tell you how to get it. You can't get it cheap. Volcker did not squeeze inflation out of the system in 1979-80 costlessly.

Representative HAMILTON. And it hurt.

Dr. SAMUELSON. It hurt. And that kind of hurt does not hurt equally. And it's an illusion to think that inflation is like smallpox. We got that last case of smallpox in Abyssinia, and it is gone. There's never a time when you're going to get inflation gone. It's like keeping your weight down; it's eternal vigilance. So by the time you put the system through that wringer, you aren't guaranteed that it's going to be easy from then on to maintain that situation. And I think that should be a current decision. So, I'm against these binding previous resolutions.

Representative HAMILTON. Let me ask this question. If you look at the economy's performance for the last couple of years, you've had a recession. Not only have you had a recession but during the period prior to the recession—for I don't know how long, at least a year—you had stagnation. We went into the recession from a period of stagnation. We're now, we think, coming out of the recession. And, if what you say is accurate, we're not going to come out of the recession with a lot of zest. It's going to be a saucer rather than a vee on the charts. That's not satisfactory. That is an economy in recent months and years that has been performing way under what we'd like it to do, maybe what the potential is. And so the question for the policymaker, it seems to me, is how do

you get this economy performing with strength so that we have real growth, zest, and vigor? What do we need to do now, in a policy sense, that we apparently haven't done?

Dr. SAMUELSON. Well, I want to mildly dissent or qualify. It is true that after 1987, 1988, 1989, before it could be said that the American economy had turned down, it had gone into what was called a soft landing—a less boisterous rate of growth. I think that was inevitable. Because I judge what is vigorous or what is too little in terms of where we are in terms of the potential high-employment capacity. And in this particular period, we had gotten to the neighborhood of 5 percent unemployment. Many economists prior to then—people I respect—had said that when you get down below 6 percent you're entering into a zone of accelerating inflation. I was pleasantly surprised that we seemed to have so little acceleration. But I think when you get the unemployment rate down to that level, then you can only grow as fast as the fundamental long-term productivity trend of the economy.

I think it would be asking too much of the Federal Reserve to ensure in the last part of the 1980s—in the seventh year of the recovery— the same rate of growth that it was quite easily able to maintain at the early post-1982 years of recovery. I think it was doing quite well until 2 years ago. But I think it's quite hard to do the macroeconomic job tolerably well just bumping along the ceiling of the high-employment situation. And so, when I was slightly marking down the Federal Reserve and not giving it an A but only a B, it was not because it failed to have vigorous growth as you were describing. I fault it for not leaning hard against the wind of a threatening recession. That was my criticism. I think for more vigorous and sustained growth at high employment, we have to direct ourselves to the supply-side economics.

Representative HAMILTON. OK. That's what I wanted to ask. Let's look at the future here and let's forget the past for a moment. I guess the question is how do you achieve faster growth? How do we get our standard of living coming back up again? You began by saying we've been pretty flat, and we're paying the bills now because two people are working instead of one. How do we get our growth moving, and how do we get our standard of living going up again?

Dr. SAMUELSON. Well, going to supply-side economics, we can do it by more capital formation, machinery and human capital formation. We could also do it by some change in attitude—attitudes on the job. I don't really know how a congressional committee is going to be able to change attitudes in an affluent society. You certainly can't have a society completely relaxed in youth and adolescence, and then think that when they suddenly enter the factory or the office door they're going to snap back to earlier standards of effort. It can be done, but it cannot be engineered.

Representative HAMILTON. When you talk about capital formation and insufficient capital formation, how do you get more capital formation?

Dr. SAMUELSON. You get it by more savings—more savings that are kept by proper Federal Reserve policy from ever being dissipated in recession conditions. You have to have more savings. But if Herbert Hoover had asked people to save more in 1931 or 1932, when already the results of potential savings were not being realized in capital formation, that would have been a very bad joke. We know how to run the system better now.

I had some prepared remarks that I didn't type, but I was prepared to give. There are special things like investment tax credits that could be used to increase machine tools. I was one of the generators of those devices in the Kennedy work teams. I was 50 percent of the people who testified in favor of investment tax credit—or 33.3 percent depending on how you count the Secretary of the Treasury—who was a captive witness. Only one businessperson could be found to testify in favor of the Kennedy investment tax credit. But still, I must seriously say, that's not the best way to run the railroad. A lot of the excesses in real estate, forestry, and other places are because a sweetheart deal is legislated by Congress so that more resources go into them. The power to reduce taxes is a power to expand the sector. The best way to have the overall interest cost and the availability of capital descend as more savings are available is to have the Federal Reserve always ensure that this does not dissipate itself into a recession, rather than to rely on these sweetheart deals.

Representative HAMILTON. You've got a sentence in your prepared statement that you read from earlier today: "... government policy cannot much affect private saving propensities." Does that mean that you don't have a lot of confidence in incentives that we put into the tax law to encourage private savings?

Dr. SAMUELSON. Yes. Let me expand my view. This is not a view based on methodological philosophy or ideology. Let's take something specific, like IRAs. We had a brief period in which anyone could have a quite generous IRA. There's a little bit of evidence in the data that the IRAs went up. Now, I will testify on the Samuelson family. Seven IRAs went up and seven Fidelity money-market funds went down by exactly the amount that they went up. One telephone call was able to accomplish that.

Representative HAMILTON. So you don't get any increase in net savings?

Dr. SAMUELSON. No, not much. First of all, economic theory tells you that getting a higher interest rate can cause you to save more or to save less; it's equivocal. There is some Canadian evidence that an IRA-like program increases the savings rate of a nation. So to speak, this is the only impressive case study in the Harvard Business School library. I suspect it had something to do with a Canadian social contagion that inexplicably caught on, like a fad for short skirts.

In fact, for a low-bracket person who's rational, the IRA saving on taxation is really minimal. Economic law says it shouldn't be a very effective thing except when that person misunderstands it. For a very high-bracket person, this is not big potatoes.

So, if you go down the list of prosaving legislation—and there's many a trade association who will give you the shopping list—and actually look at the Ph.D. dissertations and statistical studies, it's a very gray area without a lot of hope.

Let me say that in 1981, when the supply-side economics program was mooted in Congress, for the first time in my life I found myself on a panel with conservative Republican Party economists like Paul McCracken, Alan Greenspan, and Herbert Stein and also with my Democrat friends, Walter Heller and James Tobin. We all agreed. And what we agreed on is that Arthur Laffer's supply-side proposals had little support in economic history or in the seminars of plausible neoclassical economics that would back up the implicit predictions of supply-siders.

You never get controlled experiments in economics, but a lot of water has since gone over the dam. Savings did not go up; actually savings went down. Nor did we have incentive improvements that would cause the basic productivity level that I've been crying about here to suddenly have a new upward sea change. We've had a little improvement in manufacturing productivity.

Representative HAMILTON. Let's talk a little bit about productivity for a minute. I saw an article here the other day in the *New York Times* about the necessity of getting productivity up, and a lot of economists are writing about it. What's your advice with respect to productivity growth, and how to get it up? What kinds of steps ought we to be taking to get it up?

Dr. SAMUELSON. Well, I think what has increased manufacturing productivity most has probably been the ruthless competition of South Korea, Hong Kong, the Common Market, and Japan. It's been a case of sink or swim. We've even had concessions on work methods because, once it's a choice of having your plant shut down or stay in business, then you have a different kind of concession than comes just to help the profitability of the boss.

Representative HAMILTON. You were talking a moment ago about education, and I presume that's one area you would emphasize a lot harder in the productivity area?

Dr. SAMUELSON. Including the scientific area. Of course, the SEC requires me to say that I come from MIT and that I'm not without interest in the matter. [Laughter.] But it's from the post-Newtonian Revolution that the Industrial Revolution came. And after Newton is the first time in world economics that you see an increase in the standards of living on a trend basis. There was none before the 16th Century.

Representative HAMILTON. What do you think about infrastructure as being an important investment to make in terms of productivity increases?

Dr. SAMUELSON. I think there's some payoff, but I think you really have to have a cost-benefit analysis. I mean this is not a matter of sentimentality. It's got to be very hard-boiled because resources are scarce.

Representative HAMILTON. I'd like to ask you just a question or two about industrial policy and to get a sense from you on what—I know industrial policy is not a phrase used very much any more—your thoughts are with respect to that? What are the best policies for promoting American economic competitiveness? And touch, if you would, in your response, on the whole idea of industrial policy?

Dr. SAMUELSON. Many years ago now—it must be at least a decade—I was asked in a session like this to give my views on industrial policy. And then, perhaps, uncharacteristically, I came out against it; although a number of my friends were for it. I said that it was an advertising slogan looking for a product; and I can predict for you what would happen if we had a blue-ribbon commission set up to run industrial policy. It would have some professors on it—a Walter Heller or maybe a Paul Samuelson—it would have some manufacturers on it, and it would have some trade union people on it. And the first task would be to get together a bibliography to see what it is that we are studying. And the first request would be for time to work things out. And so, to give us time to work things out, the union and management members would say that they just want some temporary new quota protection because these are not permanent things. And the protections would go to those with political clout rather than to sectors most likely to become truly competitively viable.

I can not perceive, in the experience of the French Le Plan, or in the experience of Japan's MITI, or in the National Economic Development Commission in Britain—any past successes that would make me hopeful for industrial policy to tackle the problems of a decade ago; which were very much like the present problems, namely, the growing balance of payments, the deficit, and the lack of competitiveness of the American dollar and so forth.

So I would have to evaluate a concrete version of industrial policy and, even then I would, I think, come up with a mixed verdict: This part of it is productive; that part, I think, on balance would be bad. And whether the whole ball of wax would add up to more than zero, I'd want to keep an open mind on that.

Representative HAMILTON. Do the Japanese or the European experiences with industrial policy provide any model or standard for us?

Dr. SAMUELSON. Well, in this period, the Japanese have been moving away from the degree to which they had an earlier development policy. I think the scandals that we're now seeing, where the four large brokerage

concerns paid off their big customers, do not come as a surprise to the Ministry of Finance. What comes as a surprise to the Ministry of Finance is that somebody, in resigning, said that the Ministry of Finance knew about it. And a lot of the adjustments in the Japanese land boom/capital markets got delayed by that kind of Japan, Inc. planning.

The most successful case used to be thought to be de Gaulle's "Le Plan." One of the reasons for its small measure of success recorded there was that a large part of the French economy is a public-sector economy. The people who met "Le Plan" were the public railroads, the electrical industry, and the nuclear industry—all state-owned units.

America has been moving in the opposite direction not for 20 years but for 40 or 50 years. Even Sweden has been moving in this opposite direction. As Congressman Armey said, the welfare state these days is not socialism ownership by workers of the means of production, but rather it's a transfer system within a welfare context. So, I don't think there is much in "Le Plan's" experience that would encourage one to take seriously that kind of industrial policy for today's America.

Representative HAMILTON. I've got only one other question. You may want to conclude with some remarks, but the Joint Economic Committee has had an interest in the quality of economic statistics for some time. And I'd like to get your general impression, as a professional economist, how you look today on the quality of statistics. Of course, I'm thinking largely about the federal statistics.

Dr. SAMUELSON. Right, and you should, because I can tell you some of the state statistics—the cost-of-living we used to get from boiler-plate in the State House in Massachusetts—were not worth the paper that they were written on. We have very good federal statistics. And some of them have wider coverage than before. But there has been some loss in recent years from budget cutting. I think that that is cheese paring—small budget savings in comparison with the national interest in knowing, and knowing as accurately as we can know, where the economy is.

I have to agree with Professor Milton Friedman. One of the problems in 1929 and 1930 was that we didn't even know things like the money supply, and we went into the biggest depression on record. Statistics won't provide salvation but, if you're prepared for salvation, they might help you. [Laughter.]

Representative HAMILTON. Thank you very, very much for your presentation this morning. Do you have any final concluding remarks that you'd like to make? We've covered quite a few things.

Dr. SAMUELSON. No, thank you. There will be other years. [Laughter.]

Representative HAMILTON. Thank you very much, and we stand adjourned.

[Whereupon, at 11:30 p.m., the Committee adjourned, subject to the call of the Chair.]

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ROUNDTABLE CONVERSATION WITH ROBERT EISNER ON THE STATE OF THE ECONOMY AND ECONOMIC POLICY

THURSDAY, JULY 18, 1991

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

The Committee met, pursuant to notice, at 10:00 a.m., in room 2359, Rayburn House Office Building, Honorable Lee H. Hamilton (vice chairman of the Committee) presiding.

Present: Representatives Hamilton and Armey

Also present: Chad Stone, professional staff member.

OPENING STATEMENT OF REPRESENTATIVE HAMILTON, VICE CHAIRMAN

Representative HAMILTON. The meeting of the Joint Economic Committee will come to order. Today is the second of several roundtable conversations that the Joint Economic Committee will be holding with prominent economists to discuss the state of the economy and economic policy.

We are pleased to have as our guest, Robert Eisner, William R. Kenan Professor of Economics, Northwestern University. Professor Eisner has made important contributions over the years in areas ranging from the determinants of investment to how we measure national income. He has gained a reputation in recent years for challenging conventional wisdom about the economics of budget deficits.

Professor Eisner, we are very pleased to have you with us and we look forward to having a nice, stimulating conversation with you.

How would you like to begin? Would you like to begin with an opening statement of some kind? We didn't ask you to prepare one. Or would you like to just begin with some questions?

Mr. EISNER. Either way. I can talk for 30 seconds or 30 minutes. I think I can best talk for 30 seconds.

Representative HAMILTON. Why don't you just give us a quick view of where you see the economy today and where it is going.

STATEMENT OF ROBERT EISNER, WILLIAM R. KENAN PROFESSOR OF ECONOMICS, NORTHWESTERN UNIVERSITY

Mr. EISNER. Very quickly now, I would suggest that I am not one who cries gloom and doom. My view of the U.S. economy is that it is the strongest economy, by far, in the world.

We talk about other countries overtaking us. I think that is foolish in that our economy is not going down. Others are maybe catching up, which is to be expected and all for the good.

I do think that we have real problems. They are not the problems that are generally getting as much attention as they should.

We have focused, I think, as you mentioned in your opening statement, on political, rhetorical issues, on mismeasured budget deficits. Very real deficits, I keep insisting, involve our provision for the future that, in large part, is determined by government policy.

They involve saving and investment for the future. This is not the saving and investment traditionally measured, but a much broader concept involving not only business and private investment—as important as that is—but investment by households themselves in durable goods and, most important, government infrastructure, education, and research.

I worry about a large part of the population growing up functionally illiterate. Utterly unequipped for competing in the modern, advanced world.

I am concerned, of course, about the problems of drugs and crime. As has been remarked—it's hardly original with me—we seem able in no time to mobilize tremendous forces to win the war in the Middle East; yet, somehow we are paralyzed at mobilizing major forces, unleashing private forces in conjunction with public forces to meet the much more serious problems of change at home.

That's about my assessment.

Representative HAMILTON. Fine. Dick, you go ahead and take the time and I'll pick up after you finish.

Representative ARMEY. Let me first thank you, Professor, for coming over today. We had a chance to have dinner the other night and that was a rather lively debate. I think I got the short end of it.

Mr. EISNER. You were surrounded by too many academicians and ex-academicians.

Representative ARMEY. I was surrounded. You know I have not—I'm sorry to say—been a student in recent years of national income accounting techniques. So, I would like if you could give me a capsule summary of what we need to do by way of obtaining greater accuracy. I think you are also saying realism in measuring what is the national debt.

Mr. EISNER. It is both the debt and the deficit. The two are related in ways that just a surprising number of lay people and journalists seem to miss.

What we call the deficit in principle is the difference between expenditures and receipts. The deficit then adds to the debt each year. When you look at it that way, you have to then recognize quickly the need for an adjustment because of inflation.

Most economists who have studied it—if they think about it—would argue that a major impact of the deficit in increasing the debt is to give people—agents, as we call them—the perception that they are wealthier. If I give a person a million dollars in Treasury notes—somebody has to get a million dollars in Treasury notes if the government runs a million dollar deficit—then that person feels richer; therefore, he's likely to spend more.

As we measure saving as the difference between income and consumption, if he's spending more, if he's consuming more, his measure of saving is going to be less.

One big problem is that in real terms the debt has not gone up if inflation has risen more than the debt. So, as I frequently put it today, let's take a round number: a reasonably correctly measured nominal deficit of $200 billion; leaving out savings and loan, which should not be included; and not excluding Social Security receipts, which certainly should be counted; and perhaps even leaving out the effects of the current recession.

If you have a $200 billion deficit but the government already owes $2,500 billion to the public, which is about true, and if inflation is at 4 percent the $200 billion deficit is not, in real terms, adjusted for inflation. Thus, while the deficit is raising the debt from $2,500 billion to $2,700 billion because of the 4 percent inflation, 4 percent of the $2,500 billion is knocking off $100 million right there in real terms. It's what I call an inflation tax. That means if you make that adjustment for inflation your deficit is not $200 billion but $100 billion. The impact on the economy is roughly the impact that you would have if you had no inflation but had a $100 million deficit.

The second big adjustment that you have to make is one which is natural to any private business, but government does accept that kind of accounting. You have to distinguish between capital expenditures and current expenditures. By the way the Federal Government accounts for things, almost every private business, large corporations would be showing losses or deficits. But General Motors, IBM, they don't put their capital expenditures in the current account.

Then there is another adjustment that has to be made for the fact that the Federal Government is actually contributing about $130 billion dollars in grants in aid to states and localities. They, in turn, have been running up surpluses. So it makes sense, if you are looking for the total impact on government policy on the economy, to look at the total deficit.

Well, you make all those adjustments and you suddenly see, for one thing, that the conventional measures haven't made much sense. We can't tell until we measure correctly whether a deficit is too large or too small. I have one simple rule of thumb that cuts through a lot of this. That is to ask whether the debt is growing faster than the national income.

While there are many differences between government and private economy, one thing does stand out, you have to have something relative to measure against. Everything is growing. You can say, well, we've never had it so good because, even with recession, more people are working than 2 years or 3 years ago. The country is growing. You have to recognize that. So everything is bigger. Private debt is bigger. Business debt is bigger. You would expect government debt to grow, too, unless you want to have some not too secret agenda of a starving government. A lot of people have. You may have had that yourself, Congressman Armey. But if you are not trying to starve government in principle, then you might say, well, why should government debt be different from private debt?

Debt can grow too fast and you may find your debt growing faster than your income and you are in trouble. But if the government debt is not growing faster than the national income, at least as a first rule of thumb, you are within what I would call normal bounds. Except for the current recession, that has been true now for several years. The debt is about three-sevenths of GNP, just about 43 percent and stable.

The next problem related to this whole matter of capital expenditure, though, is the big difference that I was hinting at in my initial remarks. That's the issue of what the government is spending for. I raised the question of spending for the future, providing for the future. There is a big issue. Official measures don't tell us anything about that because we have lumped the whole thing together.

If we look at total government spending—you know, I could argue that I think the deficit is not particularly too big, although I'm not trying to increase it. But it is another matter if you tell me you want to increase the deficit to spend it on things that would be productive that we could agree on; whether it's highways, bridges, protecting the environment, or investing in education and research.

Some of that is related to another huge problem and that is the distribution of income. The distribution of income has been getting worse in the view of most people.

While the economy has been growing, I think there is no question that it is just a few percent at the top who have huge increases. The people at the bottom have gotten worse off and most of the people in the middle have been squeezed. I don't know that the answer to this is simply giving money to the poor. The answer is investing in the poor, or helping them invest in themselves, so they can be productive citizens.

I think I've gone on too long.

Representative ARMEY. Of course, I don't agree with your distributional analysis, but I think one of the things you are saying is we ought to look at the big G called government expenditure, and we ought to differentiate that there is capital expenditure, that there is consumption expenditure, essentially.

I've always been kind of inclined ... obviously, if you build roads, bridges, dams, what we generally understand as capital or public infrastructure, this goes in the K column.

One of the things I'm distressed by is that it seems that since the 1960s we have moved away from that traditional expenditure and moved more toward the consumption column.

But if I could take just a moment, Mr. Chairman, and ask one of the things that fascinates me is military expenditure. Do you put military expenditure down as a consuming activity or as a capital activity?

Mr. EISNER. In fact, I will probably offend some of my liberal friends by insisting that, as an economist, I won't make the distinction of excluding the military from the capital-consumption breakdown. In accounting, military expenditures and new missiles are capital expenditures. I think, unfortunately, a large part of the public investment is in the military which, particularly with the recent budget agreement, cannot then be diverted into other public investments. But I would say that a very large amount of military expenditures can only be classified as investment. Take Star Wars. However you feel about it, nobody can honestly believe that Star Wars is doing anything right now. If it were ever perfected and put into operation, you are talking about benefits to be achieved 10 to 20 years from now. That doesn't mean if you leave it out of the current account so it doesn't contribute to the current deficit that that excuses it from scrutiny. Just as any business, you don't go ahead and make a worthless investment. But you should distinguish between what is investment and what is consumption.

The great part of federal expenditures for goods and services are military. I don't know if that's widely recognized, but you can check it in any basic statistics. Those are still about two-thirds. A great part of the tangible federal investment is just for the military. You are quite right. Certainly, as a proportion of GNP and, I believe, in per capita terms, public investment has been declining.

Representative ARMEY. First of all, my general position is that it is regrettable any time you have to spend resources on arms, any kind. To me, war is a waste. Whether it is for preparing for it, executing it, or hoping to deter it. It's a shame. A shameful waste of resources. But my thinking is this: you cannot have a stable, growing economy unless you have a system of political and civil security. A system of justice that is predictable, in place. I mean, obviously some systems of justice are better than others. But predictability, I think it is very important, the key element.

My thinking is that if, in fact, defense spending does assure the security and stability of the system of justice—that is, the purchase of the first, most essential public infrastructure capital commodity called security—national security has to be seen as a capital commodity.

Mr. EISNER. There is no question that you are right on that. The only question is which expenditures are useful and where they could have been diverted otherwise.

I could raise the question as to whether you thought taking $20 billion from national defense and putting it into police, or whatever else, to eliminate crime in the cities would add more to output, or perhaps add more to investment.

American investors are loath to go into the Soviet Union because they don't know if their investments will be secure. Well, how about American investors going into the ghettos? Who wants to start a business when the place may be burnt up, blown up?

Representative ARMEY. I agree with you. If I can finish with one of my favorite observations. It is that nobody ever spent somebody else's money as wisely as they spend their own. The government is in the business of spending other people's money. It is precisely that question of is this the appropriate expenditure or not, is where we of course must tend to our needs.

Thank you, Mr. Chairman. And I want to thank you again, very much. I very much enjoyed it and I'm sorry, sincerely sorry, that I cannot stay longer.

Representative HAMILTON. OK. Let's try to go on here and pick up where we left off a moment ago.

You saw, probably, that Mr. Greenspan made his assessment—I guess he's probably required to do so by law—of the economy. And that he gave one of the most optimistic assessments of the economy that we've heard here for a long time.

Just to give you a flavor of it, he said, "That at this stage we are well on the path of actually achieving the type of goals, which we'd set out to achieve, of economic recovery, with the unemployment rate going down to its lowest sustainable long-term rate, with growth at or close to its maximum long-term sustainable pace, and with inflation wholly under control." It doesn't get any better. You will never find a policymaker make a more optimistic statement. That's the most optimistic statement I have ever heard from a policymaker. Is that warranted?

Mr. EISNER. I would say that it is not warranted, although let me add that I am not in the business of making projections. I think they are difficult. All you can do, I informally remarked earlier, is to set up a probability distribution of what you think might happen.

Mr. Greenspan is probably as well informed as anybody. It has been his business for some time. He has access to all of the figures. But what he might well say is, in his view, there is a 50 percent chance for growth of 3 percent next year, and a 25 percent chance for growth at 4 percent,

and a 25 percent chance it will grow at less than 3 percent on down, maybe to minus 1 percent.

That raises a question, policywise, as to what risks you want to take. But I think hidden in those remarks—although it sounds very optimistic—is the acceptance by Mr. Greenspan of goals that I think are not correct and are much too low. For example, he talks about the largest sustainable rate of economic growth which, given the fact that we have considerable slack capacity now and have not grown probably for several years, suggests forgetting this down side and never quite catching up. He talked about the lowest sustainable rate of unemployment, and I have had quarrels for some time now with colleagues in my profession and with Mr. Greenspan as to what the lowest rate of unemployment is. He may have in mind ... I don't know if he has in mind 6 percent, which too many of my colleagues are saying was the lowest rate. We were at around 5 percent for the better part of 2 years without any disaster to the economy. Who says there is no reason why we shouldn't be lower.

I am old enough to recall our 4 percent targets of 30 years ago. That strikes me as still a reasonable target. So, when Mr. Greenspan talks about getting to the lowest sustainable rate, if he means getting back to 6 percent or even 5 percent, that's not good enough for me. If he talks, as he does, of having a rate of growth of 1 or 2 percent over the next year and then moving to 3 percent, those too strike me as insufficient, given the fact that 3 percent is probably not an unreasonable long-run figure, but if it already dipped you want to get back toward a peak path and then grow at 3 percent. There is no allowance for that.

So, I would say that—policywise—I've listened to that kind of projection and estimate and say, what are my priorities, what does that mean, and what risks should we take on inflation?

Inflation, to my mind, has not been a serious problem for some time. I think what inflation we've had has been misunderstood. It has not been due to excess demand, or to too high a rate of employment, or a low rate of unemployment, but it has rather been due to supply shocks and, to some extent, self-inflicted wounds where we prevent adequate competition.

We tend to try to protect ourselves against low prices from foreign competition and then we complain. I think this economy, if competition were adequately encouraged, would have little or no inflation.

But I would not, as Mr. Greenspan unfortunately would, cool down the economy in order to achieve a zero rate of inflation. I'm glad to see that Greenspan did acknowledge that perhaps 1 percent inflation is really zero. That's an important concession to make, to recognize the kind of quality improvement in our products.

Representative HAMILTON. Let's talk about that question of faster growth. How do you get the kind of growth that you are talking about in contrast to the kind of growth he finds sustainable? What kinds of policy changes would you make to get that kind of growth?

Mr. EISNER. They would be in three areas. In the area of fiscal policy, as I have suggested, I would free myself from the kind of, I think, misguided constraints that push us toward a too restraining fiscal policy.

We shouldn't be working to reduce deficits now. On monetary policy, we should have a much more expansionary monetary policy, one which would leave us without shortages of credit. I am quite dismayed at the kind of control the Federal Reserve and the banking community largely seems to support. The effect on the economy and their interests of zero inflation are not particularly in the interests of industry, the workers, and the country. So, we need an easier monetary policy.

Representative HAMILTON. According to the newspaper, Greenspan said the target growth rate of M2 would be about 4 percent a year. Is that too low?

Mr. EISNER. That is probably too low in terms of the needs for expansion. Let's say we have a 4 percent rate of inflation, even a 3 percent rate of inflation, and 3 percent real growth. That adds up to a 6 percent rate of growth of GNP. He's talking then about a 4 percent growth in M2. It's hard to know how much increased velocity you're likely to get.

But I think Mr. Greenspan fools himself and some other people into looking at any particular measure like M2. I mean, we used to look at M1. Now, it's M2. He will tell you there is a very regular relationship between M2 and the economy. It ain't all that regular if you look at it, certainly, in the short run; nor the long run. There are all kinds of innovations.

I think what happens is that M2 frequently tends to follow the economy. M2 is not something that Mr. Greenspan even controls that closely, because most of it does not involve Reserve requirements.

M2 responds very considerably to the needs of the economy, which is a big reason why he now finds a better correlation between M2 and the economy. But what I would look at is what shape the economy is in. If a 4 percent rate of growth leaves you with shortages of credit, with businesses unable to invest, with high real rates of interest, the answer is you have to take expansionary measures that will probably increase M2 faster. But if you start with the statement that 4 percent growth is right, it may turn out that there will be such innovations and such financial intermediation that, you know, you may find that businesses will be getting credit; they will be borrowing directly in markets instead of borrowing in such a way as to raise M2. M2 would be enough, but I wouldn't want to hang my hat on that.

Representative HAMILTON. You said there were going to be three areas.

Mr. EISNER. Yes. The third is ... Perhaps why I frequently concentrate on the first two is because they are the short-run problems, you see. The long-run problem is really a matter of developing our resources. By this I mean human resources. It is very well known that all our scores on

math and science tests, even of our best educated youngsters in suburban schools, are far behind our European and Asiatic counterparts. As I suggested, anywhere between 20, 30, and 40 percent of the people are unequipped to produce.

Representative HAMILTON. You don't worry about trying to reduce the deficit?

Mr. EISNER. No, I certainly don't.

Representative HAMILTON. That really does run counter to conventional wisdom.

Mr. EISNER. I'm sorry Mr. Obey isn't here. Several years ago, when he was Chairman of the Committee, we had a little lunch with him and some of the aides. I think he was very sympathetic then to what I was arguing.

Representative HAMILTON. Just this week we saw another huge jump in the deficit. Here it goes again. Over, what, $300 billion now. That doesn't bother you?

Mr. EISNER. No. In fact, most of that increase is really due to three factors. One of them is the recession itself. My cure for that is to end the recession. Monetary policy would help. There are other things I could suggest. We may well be coming out of it, as Mr. Greenspan suggests. But the other factors are, in the first place, insistence upon excluding Social Security Fund surpluses, which is a change in policy that I think is not sensible. In any event you have to recognize that if you are excluding $50 billion of surplus then, at least by comparison with earlier figures, it's simply an accounting change.

The third is due to the savings and loan matter. I had an article on that in a recent journal. I actually think Mr. Reischauer and Mr. Darman know that. They all know. To some extent, Mr. Reischauer said it, it is simply not proper to include that in the deficit. It just gives you weird numbers. For one year, you'll simply find that you have $40 billion less in the deficit because you haven't laid out the money, so to speak. In another year it will be different.

So, you know, I'm not one who says deficits don't matter. Frequently, people get confused on what I'm saying. I think deficits matter very much, but first you've got to measure them right. Then you have to see, given the correct measure, if it is really too large. What people don't seem to realize is that in a growing economy, growing firms will tend to have more debt year after year. The same thing, in principle, is arguably true for the Federal Government.

Representative HAMILTON. You say, if you measure it right. How would you measure it? You've given some indication. What amount do you come up with as the—I'm not sure what to call it—the real deficit?

Mr. EISNER. Well, let's see if I can remember the figures that I've come up with. If you simply look at the Federal Government itself, I would probably come up with ... this is off the cuff. I could give you the precise figures. They change, as you point out, so rapidly. I'm not sure

what we come out with. But suppose we start with a measure reflecting the recession, leaving out the Social Security surplus, leaving out the savings and loan, you're going to be in the area of, I suspect, $100 to $120 billion.

Let's take the round number of $200 billion and we can correct that. Then, I would make an adjustment for inflation and take away about 3 percent, I think that is our current rate of inflation. Perhaps 3 to 4 percent. Three percent of $2,500 billion is another $75 billion and that knocks you down to $125 billion. Then you could, in principle, knock out the whole $130 given to states and localities, but I would then take out at least $40 billion, which is the state and local surplus, when last I looked. So, that gets us down to $85 billion. Now, that, in effect, is measuring the impact on demand, which is the first thing to look at. That is, you know, not an excessive deficit. In fact, given the recession, you could well argue that we would be better off if it were larger.

But the next question is how much of the deficit is going to finance investment? If a lot of it were going to finance investment you would say, well, that's great. Particularly, if it's not causing inflation in the economy. Sometimes, we really don't want an investment boom because you don't know the results. That's hardly true now.

Just very quickly—it may be on the record—let me remind you that a better way to look at it in the case of the impact on aggregate demand is to ask, "is the debt held by the public growing at a faster rate than GNP?" In a recession you want it to grow faster than GNP. But over the long run you might say you'd like to keep it growing at the same rate, unless there is some reason to change. That means that what with a 7 percent growth in GNP and the debt $2,500 billion, 7 percent of that is what?, $175 billion. So, you could have a deficit of $175 billion. You still have the same ratio of debt to GNP year after year. Which is to say that over the long run, you can run a deficit at 3 percent of GNP, because the debt is actually three-sevenths of GNP. Three-sevenths times 7 percent nominal growth is 3 percent. That, by people who are going into this, is widely recognized.

Now, you can say, we'd rather reduce the debt-to-GNP ratio—and some of my colleagues will say that. Some will say that, well, for worthy purposes we'd like to increase it. But the correct view is very hard to get people to accept. I would say balance is a deficit that is leaving the debt-to-GNP ratio the same. Three percent of GNP is where we were before the recession. I presume we will come out of the recession and the rate will probably go down, given the deficit reduction package and that.

Representative HAMILTON. You have supported that deficit reduction package?

Mr. EISNER. No. I fear that you are going to be living with those follies. One of the biggest ones I see is this compartmentalization of expenditures so that you reduce the chance of getting a peace dividend, because you can't take the peace dividend and spend it elsewhere. That

means if you talk about cutting defense expenditures, closing a base or anything else, there are only losers. If you could say, well, you'll get a job somewhere else, then there wouldn't be as much opposition.

Representative HAMILTON. What do you do about the problem of wages and income? We had fairly regular promising, or good, solid growth on wages and income for a period of years in this country. Now, they seem to have leveled off and are growing much less. You hear an awful lot about this from families where two people are working to stay even and this kind of thing. What do you do here to increase incomes and the wage levels of people in this country?

Mr. EISNER. I might spend a moment or two on how I would interpret some of these statistics, but the one good answer I can see is to make workers more productive, which means investing to a considerable part in human capital and management, and looking for basic research that, in the long run, will improve our technology.

I think there is a distinction to be made regarding the applied R&D that businesses take on on their own, and we should not have tax incentives for that, which is again contrary, I'm afraid, to the sentiment in Congress. But there is a great need for basic research that is not to the interest of a particular business to provide.

But some of these figures, I think, can be misleading. One of the reasons why real wages have not gone up but have probably gone down, on average, is the change in the composition of the labor force. With more and more women working at lower wages, it brings down the average.

That does raise a subsidiary question. Why should women be working at lower wages? That involves a complicated matter of investing, and perhaps changing some laws and rules of investing in women, and providing them the opportunities for continuous work so they are not in and out of the labor force to take care of children. That would tend to raise productivity. I don't know that I have seen precise figures. But what one would really want is a measure of what has happened to wages, group by group.

For the same elements of the population, you see, you could have a curious statistical phenomenon. I don't know if it is true that way, but let's say that all white men have had their real wages rise, and all white women have had their real wages rise, and all blacks and other minorities have had their real wages rise. But if there are relatively more women at low wages working and relatively more minorities working—and both of these are true—the average may be coming down. To some extent that is true. I don't want to suggest that our real wages have been rising adequately. I have addressed myself to some of the ways in which we could improve that. But some of it, I think, is just a mirage.

Representative HAMILTON. When you talk to people who bring up this kind of a problem that we're not getting the kind of increases in wages

and income that we ought to get, what do you say to them? I mean your solutions are very long term.

Mr. EISNER. It's very hard to find any other solution, I suspect. It's very difficult. It's very difficult to try to explain to an individual that if you're working in an automobile plant and the automobile company tells you we can't raise your wages because of the Japanese competition, it's hard to tell them, look, your wages are too high relative to that of other workers and that's why we can't beat the competition.

Representative HAMILTON. How would you get the savings rate up?

Mr. EISNER. I would leave the private saving rate alone. I was just at—atypically for me—an American Enterprise conference where I did meet Congressman Armey. I argued, as did most people there, that the devices of offering incentives for saving that the Congress has been playing with are likely to be ineffective. In fact, in principle, I don't see any reason why the government should tell individuals to save more than they feel like saving. However, they will save more if they earn more. The one way to get more savings is to get more income.

The second major problem is that the total saving rate should include much more than what we call the private saving. Saving, to an economist, has to be equal to an investment to be embodied in anything for the economy. It can't just be pieces of paper; it has to be something real unless it's foreign investment. That real investment, though, is anything that provides for the future, which should include public investment. It should include household investment. Most important, it should involve investment in education and research. If somebody wants to provide for his children, he can do one of two things. He can say, well, I'm going to save and leave them money. Or, if he's smarter, he'll probably say, I'm going to get them the best education I can. I'll spend the money. That doesn't count as saving the way we account for things. He spends the money to send his kid to an expensive college like Northwestern University, and that's not saving. Yet, that is really saving because it is providing the human capital with which his kids can earn much more than they get out of him leaving them money.

Representative HAMILTON. You made a comment a moment ago that reminded me of a question. Industrial policy.

Mr. EISNER. Right.

Representative HAMILTON. I would just like to get your general thoughts on that.

Mr. EISNER. I have been rather reserved on the issue of industrial policy in that I share the skepticism of some of my colleagues as to whether the government is better able to decide who the winners are and who the losers will be than the private markets.

However, I would modify that reservation to say that there is a situation frequently where programs are so broad in scale or so fraught with risk that you can't expect private companies to undertake them. A

lot of that would be encompassed in the kinds of things to which I have already referred. For example, it might be good industrial policy to recognize that we have maybe 10 or 20 million potential workers who are standing around on street corners, or running numbers or dope, and are not working and are living in areas where businesses don't feel like investing.

You might need an industrial policy for that which encompasses everything from straightening out the inner cities, to educating people, to child care programs and, perhaps, given the risk, to some subsidy to firms to come in and invest in those areas. That's because there is a difference between the value of something to any individual, any individual firm, and the value to society.

Representative HAMILTON. And you are negative to the idea of the government providing any funds directly to the private sector for a particular industry? What's the phrase they use now? The pre-competitive technology? Whatever that is. Is that OK with you?

Mr. EISNER. I am, as I say, very much reserved on that. I don't like to be dogmatic, but I'm afraid that governments are not likely to know, again, better than the private market. If there is something that is pre-competitive now or that you think would be competitive in 10 years, in principle, private investors would see that. They would say, gee, here's the chance to get into some little company that's getting nowhere and we'll have a high rate of return. Now, to the extent that they don't because of risk, which is based in government policy, there may be some need for a government policy. But the danger of——

Representative HAMILTON. Are you familiar with something like Sematech, for example?

Mr. EISNER. No.

Representative HAMILTON. OK. Where we are, in fact, putting a large amount of money into a particular kind of ... well, we won't go over that.

You aren't much worried about inflation?

Mr. EISNER. No. I have insisted for a long time—aside from what Mr. Greenspan has nicely acknowledged—that our inflation measures are suspect, and he would allow 1 percent for product improvement. I find that inflation in the United States has not ever been a peacetime problem, except for the one incident of the supply shocks, as I put it, to the huge increases in petroleum prices beginning in the late 1970s. That was coupled with the increases of agricultural prices in world markets. That kind of inflation is something that you largely have to ride with. You can't try to stop it by the conventional measures of tight money or tight fiscal policy. All you do is give yourself a recession.

Representative HAMILTON. Do you think there is a trade off on the unemployment rate and inflation?

Mr. EISNER. I have been much less enthusiastic about that argument than my colleagues. In principle, I would have to say that if you try to

expand the economy beyond some point, that if you keep increasing the quantity of money and cutting taxes and raising expenditures, clearly prices will have no place to go but up. But, except in wartime, I don't see that ever happening to our economy.

So, within the range of variation we're talking about, I think it's a false issue and one that has frightened policymakers out of taking measures necessary to get us somewhere close to appropriately high or full employment.

Representative HAMILTON. I want to pick up ... I'm not sure I got your answer on savings. What do we do to encourage individual savings? How important is that to the economy today?

Mr. EISNER. I would do nothing to encourage individual saving. Again, my answer—to put it in rather colorful terms—is that Big Brother should not be telling his siblings how much to save—or his subjects, as I put it at one point. If I decide that my children and grandchildren are worthless and don't want to leave money to them, I don't have to save for them. We are probably good judges of that on an individual basis. I see no reason to bias the saving decision or to try to bias it by some kind of tax incentive. In fact, I don't think it is usually successful, so it ends up simply being a boondoggle. The saving rates are remarkably stable.

Representative HAMILTON. Are they sufficient?

Mr. EISNER. Well, again, one thing that I think is misunderstood is saving. After all, in real terms, it is adding to our capital; if it is private saving, it is going to be adding presumably to business equipment.

People keep complaining—Charlie Schultze has been complaining. I've been arguing with him for some time now on the issue of real saving, net saving, national saving going down. It may well be going down, as I acknowledge if you include all the appropriate things, but as an economy's growth levels off, real saving in principal has to go down, driving net saving to zero as the rate of growth goes to zero.

If you keep having net saving with the economy on a level path, you'd be accumulating more and more capital and, remember, if you have more and more capital you have more and more depreciation. So, you can't have a high rate of net saving if growth has slowed down.

Now, I think—in fact, it's clear that net saving has gone down over the entire world. In Japan, elsewhere, Europe. It will have to get down if the rate of growth goes down. So, I think the cart is before the horse. What we should be doing is seeing to it that our rate of growth is as rapid as it can be, and then private capital investment will be pulled along. You'll need more capital to produce 3 percent more output or 4 percent more output.

Representative HAMILTON. An increased rate of growth will——

Mr. EISNER. Will stimulate it. In fact, as you pointed out, I did do a lot of work—I haven't done so much on that in recent years—on the determinants of business investment. I've just been looking over some

new surveys on work on that, and I think there is broad agreement in the profession that the prime determinant of business investment is the growth in output, or the expected growth in output.

If a business sees a need—Mr. Iaccoca sees a need to sell more cars, to produce more cars, he'll have to expand his plant. The problem with a saving incentive is it goes quite the wrong way. You're going to tell somebody—my usual example is to suppose that the government persuades you not to buy that new car but instead to save the money the way we measure it. Is that going to lead Mr. Iaccoca to invest more or less?

The old fashioned argument, up to 50 or 60 years ago—that has had, to my mind, a curious resurgence—is that if people try to save more you inevitably get more investment. That doesn't follow at all. It's true if you do save more you'll have more investment, but that's just an accounting identity. To try to save more simply means to consume less. We've argued this for a number of years in the profession, but I think it was well established many years ago, half a century ago—I can cite the article—that up to a point more consumption is likely to increase investment because it will give businesses an incentive to get more capital. Now, beyond a certain point more consumption may well reduce investment. But it is hardly clear that we are at that point now that we want to reduce consumption. Certainly in a recession reducing consumption is going to be devastating to investment.

Representative HAMILTON. Congressman Armey, a moment ago, was talking about the big G, the government factor. How do you feel about the taxing and spending policies of government and their effect on economic growth? Is that something we really need to worry about or is it not?

Mr. EISNER. Well, there are several aspects. On the taxing side there is no doubt about our conventional ways of taxing—there is no ideal tax that's feasible. We talk about a head tax and even that would discourage people from having children. Taxes tend to distort the allocation of resources some. I do have a feeling that most conservatives tend to exaggerate that impact. It's certainly there.

I have not been a supporter of very high marginal taxes. I keep arguing for eliminating loopholes, including more people, lowering the marginal rate, and that would reduce the distortion somewhat.

Representative HAMILTON. You like the general direction of the 1986 tax law?

Mr. EISNER. Yes. The 1986 tax law, I think, was something of a miracle. I am dismayed at the efforts now to tamper with that in terms of capital gains changes, or others which I think can open Pandora's box on new loopholes.

The expenditure policies are more significant in that they determine allocation of resources. Well, that depends. If the expenditures involve

giving money to people—whether it is Social Security, unemployment benefits—then the people still determine what they're going to get.

I think, again, some people trump out figures that the government is controlling 40 or 50 percent of our GNP. I think Congressman Armey said in a talk that it is controlling directly 45 percent of GNP. I think that is not a correct statement. It doesn't control it directly. He may get at that figure by looking at total money going out, but all it controls directly is what it buys itself. Or, in some cases, like Medicare, where it determines where the expenditures will be for certain things. Beyond that the people make the decisions. Where the government is making the decision of what to spend on, it should obviously try to be sensible and not spend it on things that are wasteful, and should spend it rather on things that are productive.

Representative HAMILTON. Would you say, today, that government spending, the present composition of it, is a barrier to growth?

Mr. EISNER. It's very hard to measure. I've been in on some arguments now—the American Enterprise Institute had a conference trying to tear apart—by one David Ashauer—you've probably hear of him—in which he finds public investment, particularly for highways and transportation, hugely productive. I wouldn't want to try to defend his particular numbers.

My guess is—a little more than a guess—but I can't give you hard figures, that there is not enough public investment in a number of areas, including transportation, including much of our infrastructure and education, although there could be public financing of private education. There is not enough for the courts. Not enough for the police. There is probably, I'm afraid—some people agree, I know, and some will disagree—there is much too much for defense. I don't think we need a tax increase at the federal level. I think if you diverted a really major portion of the military expenditures to other uses you'd have enough.

Representative HAMILTON. I'll finish it up here, but you know the JEC's had an interest in economic statistics for a long time. I'd like to get your impression of the quality of the statistics today. Have they slipped a little bit? Are they better? Could we be putting quite a bit more effort into our data gathering?

Mr. EISNER. It's hard for me to make comparisons. The data, compared to other countries, are very good. But I think they have slipped. I would say much more in the way of resources should be put into them.

One of the things I specialize in is the attempt to have expanded measures of income and product, which would go beyond the market activities. We'd get comprehensive measures of all investment that is very important for problems of growth. I remember, the Bureau of Economic Analysis had a little unit working on that a few years ago, but it was cut out for budgetary reasons.

The whole question of measuring international accounts, which I've gotten into is important. The BEA has now put more resources into

revising them, and thus somewhat torpedoing the notion that we are "the world's greatest debtor nation." That is something on which I felt there was a lot of misunderstanding.

So, a quick answer would be that, though it may seem self-serving because we economists want the statistics, it would be tremendously important for business to know where we are. That involves, to my knowledge, research on output, on prices.

There is a great need for resources. I am very pleased that Mike Boskin has taken considerable initiative in pushing this. I hope the Congress will be receptive to continued increases in appropriations for statistics gathering. I mean, if you don't know where you are, it's hard to know how to get somewhere.

Representative HAMILTON. If I understand where you are at the moment on the economy, your greatest areas of dissatisfaction would be on monetary policy; you want it loosened up; you want to take some risk, as I think you said a moment ago. Then, you have a deep concern about the lack of investment in, really, human resources?

Mr. EISNER. In human resources and public capital. But then there are two other things I would add. One, I think over the long run there has been insufficient aggressive work on trying to keep full employment. We've been much too tolerant of unemployment. That involves a combination of micropolicies and macropolicies, which are not aimed at soft landings that result in recessions when you get a little bit off your mark, and that would not be satisfied with slow rates of growth.

The other problem is the problem of distribution of income that I think is getting disastrous and will have long run costs to the economy as a whole. Just as it is very difficult for the United States to live in a world, much of which is starving—whether it's the Mexicans or others trying to come across our borders—it will be increasingly difficult for middle-class and upper-class Americans to live in a country where the poor are so poor that they have lost hope, won't have jobs, and are real threats to the rest of society.

Representative HAMILTON. What would you do to correct the distribution of income?

Mr. EISNER. I think the main thing on correcting the distribution of income, aside from a better tax policy, generally——

Representative HAMILTON. Be more progressive?

Mr. EISNER. Yes. Directly and indirectly. I don't mean, by more progressive, to have a 50 percent tax on upper-income groups because that might just invite avoidance. But in many ways we have a hidden tax policy that is very regressive in terms of the whole welfare system of people who are actually discouraged from working. You go through these calculations over and over again, and you'll find a welfare mother who takes a job and then is going to be worse of than if she stays on welfare. That's a ridiculous situation. So, I think that you need a tax and welfare

system that doesn't discourage work and tends to bolster lower incomes. Both Milton Freidman, the conservative, and Jim Tobin, the liberal, long ago advocated a negative income tax and that, in principle, is the way to go.

The biggest thing by far is the investment in people, and the kind of thing that I notice Clarence Thomas is telling us and Jesse Jackson has encouraged, and that is people working and investing for themselves. That is not just a matter of preaching to them. It's a matter of having the opportunities in terms of schools, in terms of neighborhoods. I think for a lot of the poor in ghettos, I would suggest that instead of these huge, terrible housing projects you make them owners. They would take care of their own units, many of them much more than they do in a housing project, where nothing belongs to anybody.

Representative HAMILTON. OK. I think that's it unless you have anything further you'd like to add.

Mr. EISNER. No. No. I have been delighted. I most appreciate the chance to chat with you here.

Representative HAMILTON. Well, it's a pleasure to see you. Thank you for coming by. I'm sorry I detained you a little bit. We stand adjourned. Thank you.

[Whereupon, at 11:18 a.m., the Committee adjourned, subject to the call of the Chair.]

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ROUNDTABLE CONVERSATION WITH HERBERT STEIN ON THE STATE OF THE ECONOMY AND ECONOMIC POLICY

THURSDAY, AUGUST 1, 1991

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

The Committee met, pursuant to notice, at 10:10 a.m., in room 2359, Rayburn House Office Building, Honorable Lee H. Hamitlon (vice chairman of the Committee) presiding.

Present: Representatives Hamilton and Snowe.

Also present: Chad Stone, professional staff member.

OPENING STATEMENT OF REPRESENTATIVE HAMILTON, VICE CHAIRMAN

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

Today is the third of several roundtable conversations that the Joint Economic Committee will be holding with prominent economists to discuss the state of the economy and economic policy.

We are very pleased to have as our guest today Herbert Stein, a Senior Fellow at the American Enterprise Institute. In his own words, Herb Stein has played the role of inside-the-beltway adviser on economic policy longer than any other adviser who is now even slightly active, and probably even longer than all the rest. [Laughter.]

He served as Chairman of the Council of Economic Advisers under Richard Nixon, and writes regularly on economic policy in a style that combines dry wit with keen analysis.

We are very pleased to have you, Dr. Stein, and we look forward to our conversation with you.

Really, what we are after here in these conversations is not the kind of testimony you have given so frequently before congressional committees, but to just get a sense of where you think the economy is, what you think we are doing right, and what you think we are doing wrong with respect to policy. It is kind of the broad-brush approach, if you would. We did not ask you to prepare a statement.

Mr. STEIN. Good morning.

Representative HAMILTON. You know Congresswoman Snowe.

Mr. STEIN. How do you do.

Representative SNOWE. Welcome. Nice to see you.

Mr. STEIN. I have just come from your State. I took a vacation in Bar Harbor.

Representative SNOWE. Right. Did we treat you well?

Mr. STEIN. Wonderful. Wonderful. [Laughter.] But I read about you every morning in the Bangor News. [Laughter.]

Representative SNOWE. I think it was on one subject matter, too, Loring?

Mr. STEIN. Loring Air Force Base.

Representative HAMILTON. So, what we would like to do is just have you open up with whatever comments you think would be interesting to us, and then let us take it from there.

STATEMENT OF HERBERT STEIN, SENIOR FELLOW AMERICAN ENTERPRISE INSTITUTE

Mr. STEIN. Well, I thank you for inviting me. I think this is a very good idea to do this. I will explain what is on my mind in a very general way, and perhaps mostly about what is not on my mind. The first thing people ask an economist these days is about the recession. I am not in the forecasting business, and I do not have any special insight into whether the recession is ending or not, or how rapidly it will end, but my general view about recessions, which I incorporated into an article that I wrote—and I think I brought two copies——

Representative HAMILTON. Without any objection, we will make this a part of the record.

[The article by Mr. Stein follows:]

ARTICLE BY HERBERT STEIN

REFLECTIONS ON RECESSIONS

By Herbert Stein

THE RECESSION THAT BEGAN in 1990 may have ended by the time this article appears in print. In fact, it may have already ended as I write these words in early June 1991. I cannot tell from the data now available, but neither can I tell if this recession will continue for several quarters longer. I make no predictions except that this is not the last recession we will ever experience in the United States and that the subject of recessions will remain of interest for a while.

I do not want to sound like a survivor of the Johnstown Flood commenting on one of Washington's April showers, but to one who lived through the Great Depression of the 1930s, the most remarkable thing about all other economic declines is how mild they have been.

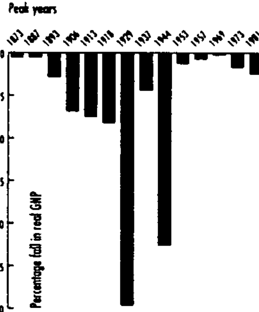
Figure 1 shows the percentage by which real Gross National Product fell in the years of decline since 1869. The decline from 1929 to 1933, almost 30 percent, dwarfs all others except the decline from 1944 to 1947, which was not really a recession at all but an adjustment from the exceptionally high rates of output achieved during World War II. Even the declines of 1913 and 1918 were war-related, the former being affected by the outbreak of World War I in Europe and the latter by the end of that war. The only peacetime drop that exceeded 5 percent was the 7 percent decline from 1906 to 1908.

What is surprising in these figures is how small the declines of 1873 and 1893 now look. When I was in college studying economics during the Great Depression, 1873 and 1893 were known to us as years of depression that were not dramatically different from what we were then experiencing.

The seriousness of a recession depends not only on its depth but also on its duration. Figure 2 shows the number of years that elapsed from the peak of GNP just before a recession to the point at which the peak was regained after a recession. Aside from the Great Depression and the declines that began with the end of World War I and the end of World War II, there have been 12 recessions. In nine of them, the peak was regained in the second year, and in three cases it was regained in the third year.

The declines of GNP in recessions would look larger if we measured the drops from the highest quarter to the lowest rather than from the highest year to the lowest. But, of course, the declines in quarterly figures measure changes that may be quite brief. A sharp drop from a brief high level to a low level that lasted only a short time is probably less serious than a smaller but more lasting decline.

1. Declines in Recessions
Peak years



Source: Gordon and Balke, *The Estimation of Prewar GNP: Methodology and New Evidence*. National Bureau of Economic Research, Working paper 2674, August 1988.

In the short run, the performance of the economy probably should be measured by consumption per capita rather than by total output (GNP). That is, the whole economic enterprise can be viewed as a way of providing for personal consumption, with investment regarded as provision for future consumption. From the standpoint of human satisfaction, it is probably more important that the growth of per capita consumption be stable than that the rate of investment be growing steadily. In fact, a steady growth of investment may not be optimal if the opportunities for efficient investment are greater at one time than another.

The path of per-capita consumption in the post-World War II period has been even more stable than the path of total output. There have been only three years in the postwar period in which per-capita real consumption expenditures declined: 1973-1974, 1979-1980, and 1989-1990. The largest of these declines was 1.8 percent in 1973-1974, when gasoline was scarce and auto sales plummeted.

Recessions have been measured in the preceding paragraphs as it is usually done, by the size of absolute declines from one year to another. The fact that the declines are few and small does not necessarily mean that the economy is extremely stable. The economy has a strong growth trend, so there can be considerable variation around that trend while the growth is rarely negative. If, for example, the economy has a "trend" growth rate of 3 percent per year and actually grows at only one percent per year for a considerable period, that would be a cause for concern even if actual output never declined.

In 1970, an economist, Solomon Fabricant, who was the research director of the National Bureau of Economic Research, proposed a new term, "growth recession," to describe situations in which the economy fell behind its growth trend but did not decline absolutely. He said

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Herbert Stein is a senior fellow at the American Enterprise Institute and coauthor (with Murray Foss) of the forthcoming book An Illustrated Guide to the American Economy *in which some of the charts in this article appear.*

further that the United States was then in a "growth recession."

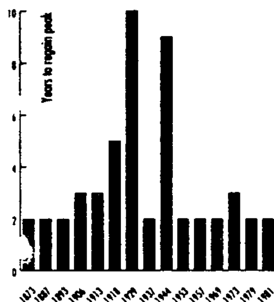
At the time, I was a member of the President's Council of Economic Advisers, and in that capacity, I found the whole idea quite offensive. Soon thereafter, I was invited to address a meeting of the National Bureau, so I opened my talk with the story of my recent encounter with Professor Fabricant when he was walking along Madison Avenue leading a little dog. I had complimented him on the appearance of the dog. "That's not a dog," he replied, "it's a horse."

"But Sol," I said, "he's so small."

"Oh, yes," he explained, "he's a growth horse."

My point was that the word "recession" had a certain significance in popular and political discourse, meaning a condition of some seriousness that should not be allowed to occur, that did not have to be allowed to occur, and that implied some fault on the part of policymakers if it did occur. Being then on the side of the policymakers, I naturally did not want the word to be applied loosely, even if qualified by the word "growth." But if I had not been in that position, I still would not have thought it reasonable to assert an expectation that the economy could, or should, be kept close to its growth trend, year by year. There was also the practical consideration that no one could know what the trend was until long after the fact.

2. Years to Regain Peak GNP
Peak years

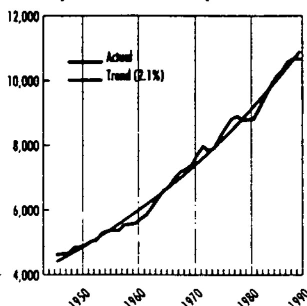


Source: Gordon and Balke

It is also true that applying the word "recession," with its negative connotations, to declines of the economy is unrealistic, especially when the declines are small. But that is less true than when we are only talking about deviations from a growth trend.

In any case, the deviations from the trend have also turned out to be rather small. Figure 3 compares actual real personal consumption expenditures per capita with a growth trend of 2.1 percent per year for the period 1947-1990. The maximum deviation below this trend is a little less than 6 percent, reached in both 1962 and 1982. Oddly, in the year of my encounter with Mr. Fabricant, the actual personal consumption was about 1.5 percent above the trend.

3. Personal Consumption Expenditures Per Capita 1987 dollars



Source: Department of Commerce, Bureau of Economic Analysis

It seems clear that the main harm of recessions like those we have had in the postwar period results from the way the "costs" (unemployment is one example) have been distributed. That is, the costs would have been slight if they had been equally distributed among the population. They would not have reduced output or consumption per capita below the levels experienced a year or two earlier. This was much less true during the Great Depression of 1929, when the loss of total output was so great. But even then, the great concern was for the fraction of the population—dispossessed farmers and, most of all, the unemployed—on whom the costs were concentrated. That was why the Employment Act of 1946 was the employment act and not the production act or the economic growth act.

Unemployment

Figure 4 shows the unemployment rate in years when it was the highest from 1933 to 1982. Again, the uniqueness of the Great Depression stands out. Figure 4 also shows how much of the unemployment in each year was due to the increase in unemployment from its previous low level. While the cyclical, or recessionary, element in unemployment was enormously greater in 1933 than the prosperity level of 1929, unemployment due to recessions was smaller in the postwar period than the unemployment we always had with us.

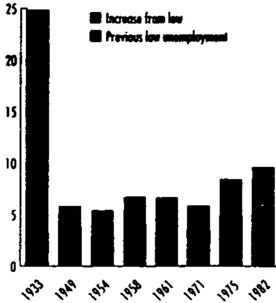
At the end of World War II, we thought of unemployment in America as consisting of two parts. One was "frictional and seasonal," which might amount to 3 or 4 percent of the labor force and was not a great problem because it was small and because it was part of the normal working of the market. The real problem was the other kind of unemployment, the "cyclical" part,

which could be much larger and which was due to policy failures that we knew how to correct—at least in theory.

The cyclical element in unemployment has been much lower than had been feared after the Great Depression, but the "normal" level has been a little higher. And the normal level no longer seems adequately described by the term "frictional and seasonal." There is now a concentration of unemployment among certain groups in the population that does not seem to be explained by such bland terms. The difference between unemployment rates for white and black workers is illustrated in Figure 5. For the past two decades, the unemployment rate for black adult males has been about as high in the best of times as for white adult males in the worst of times.

4. Unemployment Rates

Years of high unemployment

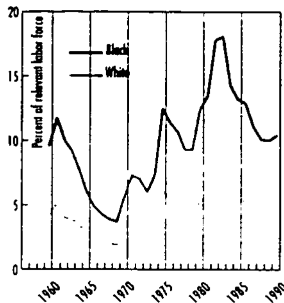


Source Department of Commerce

Another way to look at the hardship inflicted upon certain groups in the population is to consider measurements of the proportion of the population in poverty as shown by official definitions that, although arbitrary as to level, are probably fairly indicative of changes over time. These calculations are shown in Figure 6. Upticks in the poverty rate may be seen in the recessions of 1969 and 1973, but they are small. The substantial increase in the poverty rate from 1979 to 1983 is a puzzle. It was undoubtedly an effect to some degree of the increase in unemployment to its postwar peak in 1982, but other influences were also at work. It is worth noting that in 1989 the poverty rate was higher than in 1979 even though the unemployment rate was lower.

5. Unemployment Rates

Black and white adult males



Source Department of Labor and Bureau of the Census.

In sum, the postwar recessions have not only been significantly milder than our experience in the 1930s and what we had feared at the end of World War II but also less important as a source of unemployment or poverty than other contemporary factors.

The "Great" Difference

Economists are still arguing about why the Great Depression was so great, which is essentially the same as asking why the recessions before World War I and since World War II were so mild. Still, some relevant facts stand out. The importance of agriculture in the national economy was much greater before World War I than it was later; this was probably a factor in the mildness of the earlier recessions as measured by total output. The farm economy tends to operate with a more stable demand than other sectors and tends to respond to declines in demand by continuing production and employment while prices fall. It is noteworthy that even in the severe depression from 1929 to 1933, agricultural output did not decline, and agricultural employment dropped by only 3.5 percent while nonagricultural employment fell by 23 percent.

The behavior of the money supply in the period before World War I was also important. Between 1878 and 1920, there were only two years in which the money supply fell below the previous year's level. In each case, the decline was less than 2 percent.

In comparing the Great Depression with the postwar recessions, two facts are significant:

1. Between 1929 and 1933, the money supply fell by 30 percent. Since World War II, there has been no year in which the money supply declined. This comparison may somewhat overstate the difference in monetary behavior, because the price level fell sharply between 1929 and 1933 and has been generally rising since 1945. But even if we adjust the money supply for the price level to get a measure of the "real" money supply, there is a big difference in monetary behavior. This is partly due to institutional changes made in the 1930s that made the money supply less likely to shrink in a recession. These changes included breaking the link between money and gold and establishing bank deposit insurance. The different postwar behavior is also due to the heightened awareness of the monetary authorities of the need to avoid con-

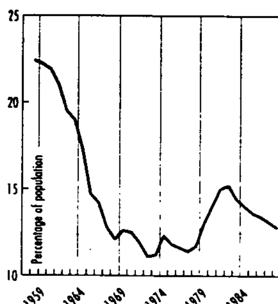
traction of the money supply in recessions.

2. Between 1929 and 1933, the real disposable income of households—that is, the income they had available to spend after paying taxes—declined sharply as employment and earnings fell. The decline in real disposable income caused a large drop in expenditures for consumption; the depressed demand for consumer goods accounted for a major part of the total decline in output. In none of the postwar recessions has real personal disposable income declined at all, and as a result, declines in real consumption have been rare and small. The main factor sustaining real personal disposable income in recessions has been the large size of transfer payments and taxes in the federal budget, which become a wedge between the incomes people earn in production and the incomes they have available to spend. In recessions, the transfer payments expand and the amount of money collected in taxes contracts, so that the effect of a decline in earned income upon disposable income is cushioned.

Policies and Attitudes

Recognition of the general mildness of recessions has greatly changed the economic policy agenda. For about 30 years after World War II, people who thought about policy leaped into action at the first whiff of recession. The air would be full of proposals and arguments about antirecession policies, and some kinds of action would be taken. In 1957 and 1958, for example, there was a heated debate about the desirability of a temporary tax cut to fight the recession. Every think tank, business and labor organization, editorial writer, and member of Congress and, of course, the president acted as though that was the main issue confronting the country. A similar, although less intense, discussion went on in the milder slowdown of 1960, and Richard Nixon later thought that failure to take antirecession action then was a major factor in his defeat in the presidential election. In 1962, even the thought that we might be going into a recession stimulated President Kennedy into proposing his big tax cut. In 1971, the prospect of going into the following year's election with an unemployment rate of 6 percent was one of several reasons for President Nixon's New Economic Policy.

8. Percentage of Population in Poverty Official Definition



Source: Department of Commerce, Bureau of Census

The turning point came, I believe, in 1975. The unemployment rate rose briefly to 9 percent. We saw that this could happen without precipitating a slide into a deep, prolonged depression. We also saw that the condition did not set off a furious political reaction. The recession probably counted against President Ford in the 1976 election, although it was not the major element in his narrow defeat. In 1980, unemployment was not even the dominant political issue, although it had risen a little. The Republicans survived the highest unemployment rate of the postwar period in 1982 without more than the normal losses in an off-year congressional election. In 1990 and 1991, despite all the incentives for the president's opponents to find a political issue in the recession, there is hardly any debate over an antirecession policy and hardly any proposal for doing anything that is not being done, except for minor differences about the degree of monetary ease or tightness.

Our lessened anxiety over recessions reflects a good deal of common sense, but there is a danger in carrying it too far. Our experience does not demonstrate that stability is a "natural" characteristic of the system. The present degree of stability has been achieved by changes in fiscal and monetary institutions and policies. We probably do not know of further institutional or policy changes that would make the economy more stable, and the search for such changes may not be very important. But it would be unwise to neglect the developments that have gotten us this far.

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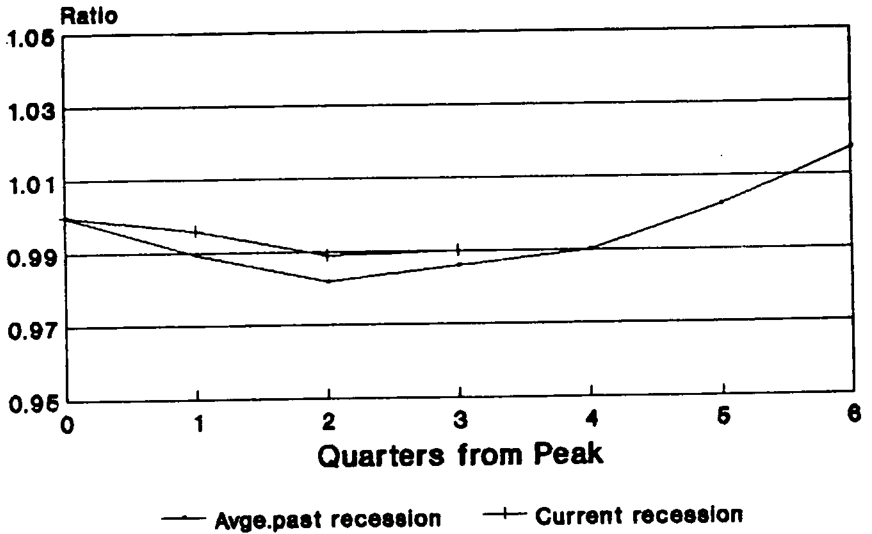
Postwar Recessions
GNP as ratio to pre-recession peak
Ratio
1.05
1.03
1.01
0.99
0.97
0.95
0
1
2
3
4
5
6
Quarters from Peak
Avge.past recession
Current recession

Mr. STEIN. ——Recessions in America are not the problem that they used to be. They are not a big American problem. The average recession in America is a very minor event in our economic life. This is a big change for a person like me, who was brought up during the Great Depression, and perhaps it is a big change for the Joint Economic Committee, which was really instituted to deal with the recessions or instabilities, depressions, cyclical unemployment as a major problem. But I think it is no longer a great problem in America. And as far as the current recession goes, so far it has been milder than the average postwar recession. I see no reason to think that it will not continue to be milder than the average postwar recession. The average postwar recession—and I did make a chart of this that I will give you—as measured by the GNP—output declines by less than 2 percent in the course of two quarters, and we regain the prerecession peak level of output within four or five quarters from the peak.[1] So far in this recession, the decline has been less than 2 percent, less than average. Our typical path of recovery is one that rises slowly in the first and second quarters of recovery and then accelerates. And if you have a path in which the underlying path is very slow growth and the economy wobbles at all, or the measurement of the economy wobbles at all, you can have some negative periods, slight negative periods during the recovery itself, which gives you the kind of "W" thing that people are worried about. So, anyway, I do not deny that there is a problem here, but I do not think it is was one of America's economic problems.

There is a great concern about the unemployed people, but as I note in this article that I wrote, the rise of unemployment during recessions in the postwar period is rather small relative to the unemployment that we have all the time, and the unemployment that we have during recessions is much less than the unemployment that some categories of our population suffer in the best of times. The average unemployment of whites in the worst of our recessions is much less than the average unemployment of blacks in the best of times.

So, I do not think we should ignore the problem of the recession. I think the fact is that the one reason they are so mild, or have been so mild, is that policy on the whole has been built up to deal with them. And I think we have now a fairly successful monetary policy, and we have built-in stabilizers in the budget that are working. We do not really know much more than that to do, and I do not think that is a great problem.

Another aspect of the American economy that people worry about is the rate of growth. The fact is that the rate of growth is lower than it has been at some times in the past. I think it is worth pointing out that we typically make comparisons of the rate of economic growth in America with the years, say 1948 to 1973, or something like that, which were quite

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[1] See chart on p. 55 of hearing, following article, "Reflections on Recessions."

exceptional in the long view of American history. Our rate of growth since 1973 has been about like it was from 1869 to 1948, or so.

So, I do not think our situation is particularly unusual. But more than that, I would say that, although it would be good if we were growing more rapidly, that is not one of America's big problems either.

We are a very rich country. That is a basic position. We are a very rich country. We are getting richer. We are going to continue to get richer, and I do not think it is of the utmost importance that we should get richer faster.

What I do think is the real problem is that we do not use our riches very well. We have problems in this country that a country as rich as ours ought not to have. We ought to be devoting more of these resources, this enormous $6 trillion economy, to the solution of some of the problems that are not solved automatically by the growth of the economy.

So, then I get down to the questions that are well known, and which I think are arising increasingly in America's consciousness. Those are the problems of poverty, the problems of education, the problem of crime; and another problem that I think is not rising in our attention as it ought to, is the fact that we are a very rich country in a group of several other very rich countries—essentially Western Europe and Japan—but all of us together are living surrounded by countries in which people are miserably poor. I think that is a problem for us that we need to devote more attention to.

So, in a nutshell, what I think is great about the American economy is that it is very rich; it is getting richer and is reasonably stable; but what is not great about it is that, despite all this, we have too many poor people, some of whom are miserably poor. We have a growing generation that is woefully and inadequately educated. Our streets of our cities and even rural areas are becoming less and less safe places to live. And we are an island of wealth in an ocean of poverty around the world.

So, that is my view of the problem.

Representative HAMILTON. OK. Well, that is good. Let us just take off from there. What do you do about it? [Laughter.]

Mr. STEIN. What you do about it first at the most general level is to stop saying we are very poor, and we cannot afford to do anything.

I appeared before the House Budget Committee on Tuesday, and the Chairman introduced the discussion with me and Robert McNamara by saying, "we start with a great scarcity of resources," and when I said I did not start from that premise, he agreed that that was not the problem, that there is not a great scarcity of resources.

But I wish more people would say that publicly, and I wish the President had never said, "we have more will than wallet," because just the reverse is true.

Then I think, having recognized that we are a greatly rich country and that we have these problems, we have to say, how can we divert more of the national output to dealing with these problems?

You have to stop spending so much money on purposes that are not directed to these problems. I look at the very large amounts of money spent for Social Security benefits to people who are not poor and are getting benefits far in excess of what was paid in on their behalf. That includes people like me. [Laughter.] Because it depends very much on when you were born, and apparently I was born in a very good year from that standpoint.

I think Medicare is another big example of payments that are being made in huge amounts to people who do not justify being subsidized.

Then I think we have to have a more open-minded attitude toward taxes. I think we are not an overly taxed country. We are taxed less than the average European OECD countries, and less than Japan in relation to our GNP, and of course at the margins much less than we used to be. I think we have lots of room for raising taxes and raising revenue without adverse effects on the economy. So that is a problem of getting the money.

Another question is, "What do you do with the money?" People are always saying to me—when I say the things I do—is, well, you cannot solve these problems by throwing money at them. It seems to be true that the only problems you cannot solve by throwing money at them are other people's problems.

I think the fact is that we do know some things to do that would help to correct these problems, or to at least alleviate them, which involve the use of more money. For example, I am greatly struck by the fact that there seems to be a lot of agreement that Head Start is a very useful program for improving the educational attainment of disadvantaged people, and the President's budget is very proud of the fact that, under his proposals, Head Start will now be available to 58 percent of the eligible children. Well, I would say, "Why is it 58?" Why is it not 100 percent of the "eligible" children? Why is Head Start provided in a way that makes it not really useful when there are working mothers?

So, I think there is a problem.

The Congress or the government adopted a revised welfare program that counts heavily on the states providing job training, social services, and various other things, but a lot of the states are not providing them because they do not have the money, or at least they have not decided to raise the money. So, I think there is an area in which more money should be spent.

I think there are deep social and psychological problems connected with poverty in America that will require a more hands-on approach. I do not think that just mailing out checks is going to be a great benefit, although there will be some. I think the checks have to go with more attention, more guidance, more one-by-one assistance; but I think that we can afford that. And when I read about it and when people talk about such programs, they always say they're enormously expensive. I say, yes,

they are enormously expensive, but we are enormously rich and we can do that.

Well, anyway, that is my view.

Representative SNOWE. Is this recession any different than our previous recessions? The biggest concern I have, it seems like I have never seen a major entrenchment in industries like the banking industry for a variety of reasons; seeing New England, of course, that has been particularly hard hit, as are a number of banks that are going under, and to see obviously the real estate, the rise of bankruptcies, which is enormous in business. We have seen so many businesses in Maine, for example, closing their doors, and I wonder if they will ever be able to come back.

I remember the 1982 recession, and I think this recession is so different from the 1982 recession.

Mr. STEIN. Well, the 1982 recession was much worse than this one. The unemployment rate got up to over 11 percent, and the decline of the GNP was very big. That was a much more severe recession than this one. I think there are special features of this one, but every one has special features.

I think one aspect of our economy that has helped to make it more stable than it used to be is that it is much more diverse than it used to be. It used to be that if automobiles and housing went down, the economy went down. Those industries are no longer so large in our total.

I think that there are a lot of banks that are very reluctant to make loans because of their own situation. I think that there are a lot of banks that are in a better situation for making loans and that will make loans. Plus, I do have a great deal of confidence that the Federal Reserve is balancing this problem of liquefying the economy without reviving inflation and that they have performed very well so far, in my opinion. I am not really in a position to give them much advice, except that they have the balancing problem. I do not think we are in the kind of situation where, if the Federal Reserve puts money in, nothing happens. I do not think we are in that pushing-on-a-string situation. I think that the money will come out. I think that if it does not come out directly through the banking system, it will come out through a rise in the value of assets, including the value of bonds; and the general liquification of the country will proceed and business will rise; and I think we are seeing some turn.

Representative SNOWE. Can I just ask another question?

Representative HAMILTON. Go right ahead.

Representative SNOWE. Was there a previous recession that we can base this one on in terms of a weak reemergence from this recession? It seems to be the general consensus that we are going to come out of this in a weak fashion and that there is not going to be a strong rebound.

Mr. STEIN. My only advice about that is not to pay too much attention to a consensus, because a consensus is always looking backward.

We have had a slow start on the recovery, but it is a slow start from a very shallow recession.

The uniformity of a recovery within a course of four or five quarters in our previous history is quite striking, even though the depths of the recessions are different. I really cannot say more than that about it. Maybe, it is because I have been through so many of these. [Laughter.]

It does not seem to me of great national importance whether we regain the previous peak in the fourth quarter, or in the fifth quarter, or in the sixth quarter. I mean, I cannot tell those things. Nobody can tell those things. I am just saying that we are not in a critical situation. The economy fluctuates.

I was interested to observe that the seasonal fluctuation is bigger than the typical cyclical fluctuation. You know, all those people in Maine who are busily entertaining the tourists, they are going to be doing nothing in the winter. They are going to hole up in the winter, or else they are going to go to Florida, but they have adjusted their lives so that they do not become impoverished in the wintertime, because they know that is a regular pattern. I think that some fluctuation in the overall American economy is a regular pattern.

I think that the American people have more assets; that we have many more two-worker families, so that if one is unemployed then there is still an income coming in. I think that the recessions are much less traumatic.

Representative HAMILTON. Are recessions less traumatic because we are smarter and have figured out how to deal with them?

Mr. STEIN. Well, I would not deny that entirely. [Laughter.]

Representative HAMILTON. I mean, they are less traumatic because our policies have made them less traumatic. Is that correct?

Mr. STEIN. I think they have certainly helped. But I think the diversification of the American economy has helped. I think if you look at postwar American recessions, the only two fairly serious recessions followed quite rapid inflations. The inflation of 1974-75 followed a rapid inflation that broke out toward the end of the price control period and continued into 1974, and the 1981-1982 recession was, in part, a reaction to the previous high rate of inflation.

In both of those circumstances, our monetary policy was hobbled, and we had a great conflict about which way to go, and there was a big change in expectations. Well, that has not happened this time. I think that is another reason to think that this will not be a very serious recession.

Representative HAMILTON. One of the things that we have heard here in talking with some of the other economists that have come by is that the Fed has not been expanding the money supply fast enough, and therefore growth has not been fast enough, or that it has produced nothing more than this weak or anemic recovery. Do you come down on the side that the Fed ought to be expanding the money supply faster?

Mr. STEIN. Well, I really will not express an opinion about that, because I think that the relation between the money supply and the performance of the economy in the last several years has been so irregular that I think the best you can do is feel your way; look at where you have been, and try to adjust to where you have been; to expand if you think you have gone down too far, and to restrict if you think you are going up too fast.

So, I think I will judge the behavior of the Federal Reserve by the performance of the economy. And I think that, looked at in that way, the recession has been kept very mild. The signs of recovery have begun at an early stage, and we still have a problem with getting the inflation rate down, so I think that we are moving in a proper way. But I have some confidence that the Federal Reserve will adjust to signs that they are not moving in a proper way. Now, this is an unusual thing for me to say, because I used to be a great believer in rules of monetary policy, but I am less confident about that than I used to be.

Representative HAMILTON. One of the themes we hear a lot about here is investment. We should be investing more in the economy; we are too much on the consumption side; we are not investing enough; we are not investing wisely enough. How do you react to that? Is that one of the key problems in the American economy, as you see it today?

Mr. STEIN. Well, it is one of them but it is not the top. Some people do put it at the top of the list, but I do not because this goes back to what I said about not being terribly concerned about getting richer faster.

But the corollary to that is about consumption. I totally agree that we consume too much, and particularly that the not-poor segment of the American population, which is, say, 85 percent of it, consumes too much. I do not mean to say that they ought to be consuming less now or that we want to cut their consumption, but the rate of growth of real per capita consumption has been too fast in the last 10 years or so.

For this purpose, I exclude health and education. Part of personal consumption goes for health and education, but excluding that as well as I can, real per capita consumption has increased by 1.5 percent per annum. If it had increased by 1 percent instead of 1.5 percent, we would have had $200 billion available for other purposes. I do not think there would have been any visible difference in the American economy if per capita consumption had risen by 1 percent per annum rather than 1.5 percent per annum.

You know, there might be a few less VCRs and sporty cars—I do not want to make light of that—there would have been some difference, but it would have been a trivial difference.

I think the $200 billion could have used in much better ways. One of them would have been to invest more, but I would say, first of all, it should have been used to invest more in education, and in the health care of the uncovered, and in assistance to the poor.

I come back to the question of what do we do about the poor in other countries.

Representative SNOWE. What about the level of our deficit? Is that a concern at all, discovering another $100 billion? [Laughter.]

Mr. STEIN. The $100 billion was not in one year, was it? I read about that, also, when I was in Maine.

Representative SNOWE. Yes.

Mr. STEIN. I thought it was $100 billion. Is that the mistake you are talking about?

Representative SNOWE. Yes, that is right.

Mr. STEIN. The revenue estimate? That was for five years or so.

Representative SNOWE. The "miscalculation," right.

Mr. STEIN. Well, $20 billion a year, that's nothing. I think the concern about the deficit is essentially a concern that goes back to investment and the absorption of private savings in the deficit. That is a reason to be concerned about the deficit, and I think we should be somewhat concerned about it.

But if you ask me, if you had $50 billion of free money, would you use it to reduce the deficit or to improve education, to assist the poor, to do something about crime in America? I would say, first, do those things rather than reduce the deficit. Of course, the deficit figure is kind of crumbling in our hands, because we do not know what it is anymore. We do not know whether the S&Ls are in or out, or whether Social Security is in or out. So, I think that fact alone, the fact that nobody can understand it, is going to reduce the fear of the deficit.

Representative SNOWE. This is sort of disconcerting to know that we do not really have a handle on the size of our deficit. I mean, we talk about all these increased costs, and programs, and everything. And we are dealing with the Surface Transportation Act, and there are a lot of concern about the expansion of the number of projects and the costs of the program overall for the next five years in the authorization, and it makes me wonder how far can we go? These are certainly uncharted waters. There is no question about that. There is no precedent for this. So, where does that take us?

Mr. STEIN. Well——

Representative SNOWE. And given the fact that the interest payments on the debt is the fastest growing segment of the budget.

Mr. STEIN. Well, we have every reason to think that we have some bulge in the deficit now as a result of the savings and loan bailout costs. When you pass that period, when you begin to get recovery on those assets that the government acquires, there will be a reduction in the deficit. I think that the deficit, abstracting from that bulge, is at a level at which it can remain forever. That is, there is a size of deficit that will keep the ratio of the debt-to-the-GNP constant forever, and I think we will be in that neighborhood. In fact, I guess if the budget projections for five

years are accurate, we will be reducing the ratio of the debt-to-the-GNP, so that we will not be in an explosive situation.

We will be in a situation where it probably would be desirable to have a smaller deficit just from the standpoint of investment. I understand you have had Mr. Eisner here, and he has explained to you that a lot of those "expenditures" that are counted as expenditures in the federal budget are really investments, and that is true to some extent. But I think it is entirely a question of priorities, as all of these questions are.

I would be quite happy to forego many expenditures in the budget and to accept many kinds of revenue increase in order to reduce the deficit, but I would not want to reduce the deficit by cutting programs in the areas that I think are most important.

Representative HAMILTON. One of the things that comes across in listening to you is your concern about the poor and the underclass.

I guess the question is, why? Why should you be concerned? Are you concerned about them for humanitarian reasons, which of course are valid? Or are you concerned about that for economic reasons? Or both? Why should we be so concerned about the poor? Is that strictly a humanitarian view?

Mr. STEIN. Well, I think it is humanitarian. You can call it "humanitarian." You can call it "moral." You can call it a matter of justice. You can call it an aesthetic matter. That is, I am offended when I walk through Farragut Square and see the homeless lying on the benches. I am offended at the notion that here we are so rich, and we can see these people. I don't see them very much in person, except for the ones that are out on the street. But I can see them on TV and read about them, read the miserable stories with them, and I think that they are a part of our responsibility.

Representative HAMILTON. The reason I raised this question is, there are some people who argue that our standard of living, yours and mine—the "elite," so to speak—is not going to be able to grow in the future as it has in the past, unless we lift up this underclass and make them more productive than they are today. In other words, they make a kind of an economic argument for dealing with the problems of the underclass. Do you buy that?

Mr. STEIN. Well, I think there probably is something to that. That is, I think that there is a form of investment there that will yield a return in the national income, and that we will all share in it.

But that is not my primary concern. You see, for a long time, or for many decades, we were making progress in reducing the proportion of the population that lived in poverty. Now, for the last 10 years or more, that proportion has been fairly flat, aside from minor cyclical fluctuations. I am concerned about the fact that we are not making progress in reducing that. And, of course, the problem has become more difficult because the composition of the poverty group has changed, but I think it is the kind of thing about which you can say you either care, or you do not. If you

do not care, there is no way that I could persuade somebody to care. I could not persuade somebody that he should invest in some ghetto child in order to make his own future income, or his child's future income higher. He would probably be better off to invest in his own child, if that is the object of the game, or to invest in the Dow-Jones Indexes.

Representative HAMILTON. Would you use the tax power to help on this problem of the poor? And if so, how would you use it?

Mr. STEIN. Well, do you mean other than as a source of revenue?

Representative HAMILTON. Well, larger earned income tax credits, or whatever. In other words, when I asked you a few minutes ago how do you deal with the problems of the poor, you come back and you indicate education and so forth, which are of course very sound, but what about the fiscal power. Other than spending money for a Head Start Program or other programs that may be working well, do you use the tax power in such a way?

Mr. STEIN. Well, using the tax power in the form of these credits is the equivalent of handing out money, and I think we are going to need more direct and targeted programs for many of these people, for the hard-core of the problem. I think that that is not sufficiently direct and is not sufficiently in touch with the psychological, social, and neighborhood environment problems that are there.

Representative SNOWE. Are you referring to the bills that have been introduced on increasing the income tax credit for dependents?

Mr. STEIN. Yes.

Representative SNOWE. Which would cost about $50 billion over 5 years.

Mr. STEIN. Yes.

Representative SNOWE. So, you do not think it is specific enough and targeted?

Mr. STEIN. I do not think it is sufficiently targeted.

Representative HAMILTON. Too blunt an instrument?

Mr. STEIN. Yes.

Representative HAMILTON. What about the goal of zero inflation? Should that be a policy goal of the United States Government? We have got a bill floating around here calling for zero inflation. It has been endorsed by the Chairman of the Fed.

Mr. STEIN. Yes, well, I would be for that.

Representative HAMILTON. You would support that?

Mr. STEIN. Well, "zero"? I think, does it not say "negligible"? [Laughter.]

Representative HAMILTON. That is right. It does not use the word "zero."

Mr. STEIN. But I no longer think that it is our greatest problem, but you have to give the Federal Reserve some goal, and I think that that ought

to be their goal. [Laughter.] That is what they are there for. I think it is the most reliable goal. It is the goal that people understand best and is most likely to be sustained if it is achieved.

I think we have come along pretty well. There is always the fear, at least in my mind, that if we settled down to 4 percent, the 4 percent would become 5 percent, and the 5 percent would become 6 percent, because people would never have real confidence and would ask why did you stick at 4 percent, which is an arbitrary number? Of course, zero is an arbitrary number, also, but people do not think it is an arbitrary number. So, I think that there is an advantage to zero.

I think this is related to another matter, which is the matter of international monetary arrangements and international financial arrangements. I think that stability in the world exchange markets would be promoted if we, the Europeans, and the Japanese could agree on a target, each for our own inflation rate. And that probably the best target in that case is zero, so that we would avoid fluctuations and exchange rates that are due to different rates of inflation, or to anticipations of different rates of inflation. I think it is a good idea. I think the proposals for the European Central Bank include provisions for price-level stability as a target.

Representative SNOWE. Does it trouble you at all, the condition of our cities and our states are in and the problems that——

Mr. STEIN. Yes, it does.

Representative SNOWE. ——financial problems.

Mr. STEIN. It does, because they are the instruments through which we have to deal with most of the social problems I am talking about. I do not expect the agencies of the Federal Government to be out there doing these things, holding teenage mothers by the hand. I think it is distressing what we see about the condition of our states and localities. I think it must be said that many of them are run with terrible inefficiency. I do not know that that can be solved from here, but I think that they also suffer limitations on their revenue-raising ability, and I think it was a mistake to have given up general revenue sharing.

Representative HAMILTON. What is really unique about what you have said this morning is the emphasis that you have put on positive government measures to reduce poverty. I mean, that is the kind of thing we have not heard much of.

Representative SNOWE. That is true. We have not been hearing anything positive. [Laughter.]

Representative HAMILTON. That is rather striking to me.

Mr. STEIN. Well, but it is not new.

Representative HAMILTON. No, that is right.

Mr. STEIN. I mean, we have been in this business for a long time. I think it has been accepted for a long time that it is the responsibility of government to help to reduce poverty. We have had a lot of anti-poverty

programs through the years. We have gone through a recent period in which all that got a bad name, I think unjustifiably. I think a lot of money was certainly wasted, but I think that we cannot give up the effort.

I think I would like to say something on this subject of waste. It is really part of my own intellectual history, because 10 or 11 years ago there was a big discussion about the increase in defense expenditures. I was always a big supporter of that big increase. People said to me, well, but they waste so much money. My answer to that was, well, but the objective is critical, and if they do it wastefully, we have to give them more money, so that if they waste a quarter of the money we have to give them a third more.

I was a member of the Packard Commission and was aware of and had learned even more than I had previously known about the waste, but nothing led me to think that because part of the money was wasted that we should not give it to them. Then I would think, well, there are a lot of other programs that are criticized, and people will not give money for them because they are said to be very wasteful, but if the objective is serious we have to do it. Then I thought, well, there is waste all over.

People have the idea that private expenditures are very efficient, rational, well-informed, and government expenditures are very wasteful. Well, that is not true at all. You can look at your own expenditures, or at least mine. [Laughter.]

I look around and see all these people smoking cigarettes, chain-smokers, telling me about the rationality of private spending decisions. That does not look very rational to me. And there are plenty of other things. So, I think we have to accept the fact that there is going to be waste and irrationality all over, and say what are the important things that need to be done, and what can we do about them? And not start, a priori, with the assumption that government cannot do it.

You have to look at the particular cases and try to decide, and not say that just because it is government we are not going to give them some money. I think you also cannot say that just because it is government it is a useless instrument. It is the instrument we have.

Representative HAMILTON. I would like you to comment, if you would, on—the JEC has had this interest in economic statistics--what your impression is of the quality of our economic statistics. Has there been a decline in them? Is it a serious decline? What is your general reaction?

Mr. STEIN. I am not really close enough to that to say. I am not aware of any decline in the quality, but maybe I just do not know. I think things have become more difficult to measure. I have become more impressed with the difficulty of measuring the things that we would really like to measure. I am hooked on the GNP and all that range of figures. But if you ask me, how do I know that some real thing is 20 percent higher than it was 20 years ago, and you have all the problems of how to evaluate; how do we price things and what value should we attach; how do we

make some total out of the millions of different products of goods and services that there are in the economy, it all becomes very arbitrary.

So, I am more concerned with the conceptual problem. I think that the data are about as good as you can get, but I would not say any more about that.

I have made a point—which I think you know about—that I believe it would be important that we should have a breakdown of the GNP statistics——

Representative HAMILTON. Yes.

Mr. STEIN. ——that would show what we use the national output for, which we do not have now. I have been wrestling with that, trying to produce some figures for my testimony for the Budget Committee, and it is very hard.

Representative HAMILTON. Thank you. We will finish up pretty quickly.

One of the criticisms we get all the time is that government people are too short term in their view of things—policymakers, Executive and Legislative Branch. You hear the same criticism now about a lot of the business community: short-term balance sheet, profit for the next quarter, and that kind of thing. How do you react to that? Do you think that is really a valid criticism of the American business community and government, as well?

Mr. STEIN. Well, I really do not make that criticism of the American business community, not in general. I think we have that in financial markets, but I think that is a kind of rational response to the fact that interest rates have been very high, and if interest rates are very high, you pay a lot of attention to the near future.

I think there is an aspect to that that I think deserves some attention—more attention than we get from government. That is, the problem of the potential, and in many cases, actual conflict of interest between the private decisionmakers and the person for whom they serve as a fiduciary. I think we have that, and we see that in a lot of savings and loan scandals, and in the investment junk bond market scandals, a lot of that. That, I think is a problem.

But I have only really had connection with one substantial private enterprise, which was a manufacturing company, and it seemed to me that when they made decisions about investments, exploration, and things like that that they were looking quite far ahead. Well, this was an aluminum company. If they were going to make a large investment in bauxite mines somewhere in the world, they made a long calculation.

I think that government does suffer from too short a view. You see, we have a lot of individual programs by which long-term decisions are made, but I think that we ought to have a longer view of where we want the U.S. society and the economy to go, and where our government policies ought to be adapted to that longer term view of our objectives.

That was a subject that we talked about on Tuesday before the House Budget Committee. I thought they really were asking a good question.

That is, look to the beginning of the 21st century, look 10 years ahead. What should be our budgetary objectives? What should be our national objectives? I think that is a good framework.

Representative HAMILTON. Let me just conclude by asking you to comment on the general question of U.S. competitiveness. "Competitiveness" is kind of a key word around these places now. How do you size up U.S. competitiveness? Is it something you worry about a great deal?

Mr. STEIN. No, it is not something I worry about. In fact, I have spent a lot of time trying to defuse that argument. I think that "competitiveness" really has two dimensions. People are looking at two different kinds of things. They are looking at our foreign trade accounts, or they are looking at the relative size, total, or per capita of the U.S. economy and some others. With respect to the former, I do not think it is anything to worry about. I do not care whether we have a trade deficit or not. I think that depends and is mainly determined by exchange rates, and we see that the exchange rate is adapting and that our balance of payments' deficit is declining as a result of that, and I do not think there is anything wrong.

I think it was fortunate for us that the rest of the world was willing and able to supply us with capital during the decade of the 1980s, and the natural consequence of that is that we would have a trade deficit. On the other hand, I do not worry about the other countries becoming richer than we are. That goes back partly to what I said earlier about these conceptual problems of comparing things. Everybody cannot be the "richest" country in the world, and our problems will not be made greater or smaller by being richer or not richer than the Japanese or somebody else. Our problems are here.

I think we should look at our own problems. But I did say that I think I would like to raise again the question of attention to the problem of poverty around the rest of the world. Foreign aid has a very bad name in the U.S. Congress. I know that. I think that the American people have a very exaggerated notion of how much we spend on foreign aid.

You must have this experience much more than I do, but I sometimes have been out promoting a book and being on talk shows where people call in, and the most common question I get is, "why don't we balance the budget by cutting foreign aid?" Because people think it must be $300 billion or something like that, and it is only something like $15 billion. But also I think that people—the American people—when they are brought face to face with the miserable conditions in some parts of the world like Ethiopia, or Bangladesh, or Kurdistan, they do want to do something about it. I think it is not beyond possibility to explain to the American people that, as partners in the richest part of the world, we have some moral responsibility, some humanitarian responsibility, to do something about these other countries, let alone the problem of the instability that could be foreseen as some of them sink deeper and deeper into misery.

Representative HAMILTON. OK. Thank you very much, Dr. Stein. It is a pleasure to see you and to get some of your comments and thoughts. Thank you for joining us.

Mr. STEIN. Thank you for inviting me.

Representative HAMILTON. We stand adjourned.

[Whereupon, at 11:02 a.m., the Committee adjourned, subject to the call of the Chair.]

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