S. HRG. 102—215, PT. 2

ROUNDTABLE CONVERSATIONS ON THE STATE OF THE ECONOMY AND ECONOMIC POLICY

HEARINGS

BEFORE THE

JOINT ECONOMIC COMMITTEE
CONGRESS OF THE UNITED STATES

ONE HUNDRED SECOND CONGRESS

SECOND SESSION

PART 2

SEPTEMBER 12 AND 26, AND OCTOBER 10 AND 18, 1991

Printed for the use of the Joint Economic Committee

U.S. GOVERNMENT PRINTING OFFICE
WASHINGTON: 1992

For sale by the U.S. Government Printing Office
Superintendent of Documents, Congressional Sales Office, Washington, DC 20402
ISBN 0-16-039060-5

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[Created pursuant to Sec. 5(a) of Public Law 304, 79th Congress]

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ROUNDTABLE CONVERSATION WITH ALAN BLINDER ON THE STATE OF ECONOMY AND ECONOMIC POLICY

THURSDAY, SEPTEMBER 12, 1991

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

The Committee met, pursuant to notice, at 11:35 a.m., in room 2318, Rayburn House Office Building, Honorable Lee H. Hamilton (vice chairman of the Committee) presiding.

Present: Representative Hamilton.

Also present: Chad Stone and Douglas Koopman, professional staff members.

OPENING STATEMENT OF REPRESENTATIVE LEE H. HAMILTON, VICE CHAIRMAN

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

Today's is the fourth 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 today, Alan S. Blinder, Gordon S. Rentschler Memorial Professor of Economics at Princeton University.

Professor Blinder's economic peers know him as a skillful analyst and defender of the Keynesian approach to macroeconomic analysis. Many of the rest of us know him through his highly readable *Business Week* columns on the economy and through his book, *Hard Heads, Soft Hearts, Tough Minded Economics For a Just Society?*

We are pleased to welcome you, Professor Blinder, and we look forward to an informative and tough-minded conversation with you.

Now I would like you just to begin with your comments about the economy, any aspect of it you want to emphasize. My interest really is policy, and what you think we're doing right and what we're doing wrong with respect to the American economy today. That's what we will focus on in the questions that will follow your opening comments.

All right?

Mr. BLINDER. Fine.

Representative HAMILTON. Thank you.

STATEMENT OF ALAN BLINDER, GORDON S. RENTSCHLER MEMORIAL PROFESSOR OF ECONOMICS, PRINCETON UNIVERSITY

Mr. BLINDER. My opening comments won't be long, as I presumed we would do this more or less as a dialogue.

I would like to start with a somewhat academic, but not very academic conceptualization of the problem. I choose this dichotomization because I think the answer to the policy question dichotomizes along these lines very clearly: the dichotomy between short run and long run. The question is: How is the economy doing, short run versus long run? A very short summary of my view of policy is that it's doing pretty well for the short run but just terribly for the long run.

Now, let me just take a minute on that conceptualization. In the short run, business cycle developments tend to swamp almost everything else you can imagine. It's only a slight overstatement to say they swamp everything. For example, annual growth rates, ranging from positive 6 percent to negative 2 percent, are typically found over business cycles. If you're concerned with how is the economy doing over the next 6 to 12 to 24 months, the business cycle developments are essentially everything. In particular, things that we would call growth policy, which I want to get to today, are more or less irrelevant over such time frames.

In the long run, on the other hand, business cycle developments are essentially irrelevant and the long-run growth rate is everything. I mean here, the long-run growth rate of productivity, defined either by total factor productivity or by labor productivity, depending on the purpose you have in mind.

Small increments or decrements from the growth rate can compound to hugh amounts over two or three decades. So, whether you're worried about competitiveness, living standards, or almost anything else, it comes down at bedrock to productivity growth. So, there is, indeed, a sharp dichotomy.

So, let me just briefly say something about first, short-run policy and then, long-run policy.

For the short run, in 1991 the important thing for macroeconomic policy is to keep, or to get, the recovery on track. There is some disagreement among business cycle analysts today about whether the verb should be keep or get. My feeling is that it's probably that the economy looks OK, though a little bit on the peaked side, right now. But, basically, the prospect is for a modest but reasonable recovery.

Now, when you look at the traditional branches of stabilization policy—fiscal and monetary—it's quite clear that the fiscal arm is paralyzed or worse. It's totally paralyzed at the federal level, as you well know, as the legacy of a decade of first ignoring the budget problem and then more or less locking in fiscal policy in the 1990 budget agreement. (By the way, I don't think that was a bad thing to do by any means.)

Fiscal policy is worse than paralyzed at the state and local level, because these governments seem to be in the midst of or on the verge of raising taxes and cutting spending to get rid of their own budget problems. So, total government fiscal policy is moving in a perverse direction from a business cycle point of view, though presumably not by a large amount.

That leaves the whole burden for keeping or getting the economy on a recovery track to the Federal Reserve. With many Federal Reserve Boards, I would have been keenly worried about that. People's opinions on this differ, but my opinion is that the current Federal Reserve Board worries me less in this regard than past boards would have. That is to say, I believe the current Federal Reserve Board is quite concerned with keeping the economy growing, more so than previous Feds. They have done a quite good job, I think, with this so far, especially when you realize the difficulties caused by their stabilization policy partner, that is the Federal Government, not doing its job or even doing a perverse job.

So, I think more of the same from the Fed would be fine right now, with a little bit more easing. That is predicated on a personal judgment about how fast the economic recovery from this cyclical trough should be. What would be the right trajectory?

My personal preference would be to have the economy grow at about a 3.5 percent rate or so for 2 to 3 years. Now, it's very tough to achieve that exactly, but that's the target I would set. If I were Alan Greenspan, which is a fanciful thought, that's the sort of thing I would be trying to do, realizing I could only do it with error.

Although the Fed deliberately does not announce such goals explicitly, I have a feeling that they are shooting for a little weaker recovery than that. Private forecasters are also, for the most part, forecasting a bit weaker recovery than that.

Representative HAMILTON. Because they're worried about inflation?

Mr. BLINDER. No. I think probably the consensus among private forecasters is a little bit more worried about the Fed's behavior than I am. They may also be a little bit less believing in the economy's natural self-curative mechanisms, which in the short run are going to have to work through inventory bounce-back, and in the longer run are going to have to work through consumption and housing and other things. They may also be more worried about deterioration in our export performance, and about what might happen in the state and local sector. I think it's a question of lots of little differences accumulating. But these all don't add up to a great deal of difference of opinion about the outlook.

As to fiscal policy that I indicated a moment ago—and I think this is what I said to the Budget Committee a few months ago—the best thing that Congress could do now is to stick to the budget agreement of 1990.

If you had asked me in 1980 whether I would ever had made such a statement at the point in the business cycle where we were 4 months ago, I would have said, ludicrous.

But I, like you and all Americans, have lived through this decade of fiscal shenanigans and nonsense. So, I think anything the Congress would do now to abrogate what was a pretty good budget agreement in 1990 would just destroy any credibility that might be left.

I don't think there is much left by the way. But I think there is some, and I think credibility is something that can be rebuilt. I think Congress is helping to rebuild its credibility in this budget session precisely by sticking more or less to the 1990 agreement. So, I think that's good and should be continued, though, as I said, 10 years ago I never would have believed I would say such a thing near the bottom of a recession.

That's the short answer to your question about short-run policy, how we're doing and what we should be doing.

Let me say a little bit more about long-run policy. That means growth policy, and to me that especially means growth without worsening inequality policy. That's a very long hyphenated adjective; so, let me explain.

In the 1980s, as you well know, the avowed policy of the National Government was one of promoting growth, and the unstated corollary of that was to promote growth by promoting inequality. The rich after all are more productive than the poor. That's why they're rich! They save more and they invest more than the poor largely because they are rich. The basic strategy of the 1980s was to make things better for the rich and hope that things trickled down.

I might add that in the early days of the Reagan Administration, as you probably remember, many of the spokesmen were quite frank about that strategy to their credit, I guess. I do believe it's good to be straightforward about what you're doing and many of them were quite straightforward. Unfortunately, it didn't work very well.

I would like to point to a different sort of growth strategy for the 1990s, and to introduce the idea of what I call percolate up, rather than trickle down, by a simple analogy.

The economic argument for trickle down is valid; the only questions are its quantitative dimensions and the side effects that it causes. The argument is that, if you get more capital—I mean more capital per worker—which you get through savings, investment and so on, then labor's productivity goes up. The simple reason is that every worker has more and newer and better capital to work with. This is all true, and that's the essence of trickle down. The meaning of trickle down is you do things that are good for the capitalist class, so to speak, and the benefits trickle down to the laboring class because they get higher wages. There is definitely truth to that.

There is, however, a reciprocal argument that I think we ought to be emphasizing for our growth policy in the 1990s. Indeed, I wish we did it in the 1980s. This argument says that, if you get better, more educated labor working with better labor-management relations, then the productivity of capital will go up. So, things that are aimed directly at the working people—education, training and so on—will by indirection affect the owners of capital in a positive way. Their capital will be more productive because it is working with better workers. It's a completely symmetrical argument to trickle down.

So what are the sorts of things I mean by this labor-oriented, percolate-up policy? When I start ticking them off, you'll see exactly why I give the government such low marks for the 1980s.

I mean first of all—and when I say first, there is no particular order of importance—public infrastructure capital, which we allowed to dwindle, not only in the 1980s but earlier than that.

I recall that this Committee held a hearing, perhaps a year and half ago, in which I and several others were witnesses on this subject. I won't belabor the point. But I do try to repeat it for the record every chance I get, because in this town, as you know, you've got to repeat things a thousand times. So, without dwelling on it, I just repeat it again: more public infrastructure would assist growth.

Representative HAMILTON. Some of us learn slowly.

[Laughter.]

Mr. BLINDER. Some learn fast and some learn slowly. It's the same way where I live.

The second thing is early intervention to assist the disadvantaged. This is also something you've heard before. Now, when I say early, I mean very, very early—even before birth. Prenatal care, postnatal care and things like that, right up to preschooling and Head Start, are the things I mean.

Well, how does this fit into this schema? In a very simple way. One of the things we've done wrong in this country, in terms of utilizing our economic resources, is to simply relegate something approximating the lower 20 percent of the labor force to the social scrap heap. We don't utilize them. So, instead of becoming a productive force to help us produce more GNP, a lot of these people, unfortunately, become drains on society.

Representative HAMILTON. The lower 20 percent?

Mr. BLINDER. Something like that. It depends on precise definitions and so on, but that's a reasonable round number. So, we carry this share of the population as a handicap, whereas, in a more properly ordered society, there would be more productive citizens. That injures our competitiveness, our standard of living.

Now, early intervention naturally leads up to the school system where the last aspect of early intervention, as I see it, is preschooling. I've been very glad to see in the last few years a greatly heightened awareness in the Congress and in the Administration of the importance of Head Start. But it is still underfunded, even today. Although full funding has been pledged, you know better than I that there are some doubts about the delivery on that pledge in terms of actual appropriations rather than authorization.

I'm not an expert on the educational system, and you could easily call people here to testify that know a lot more about K-12 education than I do. But I just want to call attention to two things that really are only peripherally related to the main concerns of people who focus on K-12 education. Although these two things are rarely part of that focus, I think they are quite important for industrial productivity.

One, is the school-to-work transition, which we do rather poorly in this country. There are many ways to think about that, ranging from apprenticeship programs to more cooperation between businesses and the schools. But I think one of the fundamental problems we have in getting the school system to work better is that, in some sense, the employers don't care. How well you do in school may have very little to do with where you wind up working, and the kids know that. Another aspect of the same problem is that what is taught in the school may not be what is needed in the work place. So, I think this country has a lot to do in the school-to-work transition, some of which could redound to our benefit in terms of productivity.

The second aspect is an insufficient number of our school children—and I'm talking about older kids, high school and into college—opting for science, engineering, and mathematics, as opposed to a variety of other things. I believe, and most economists believe, I think, that there would be a productivity dividend if more kids went into science and engineering. Or, I guess, what I should say if they stayed in. We do, after all, throw them all into it in the early stages of school. But we don't do it very well, and they start dropping out very, very rapidly. So, by the time you get up to the university level, really quite a low number of students are specializing in science and engineering, relative to what I think we ought to be doing.

There are some things the Federal Government could do about that, such as bring back the National Defense Education Act, for example. I guess we would use a different name now. It would be the National Productivity Defense Education Act or something like that. But it's the same idea.

The last thing I would like to call attention to, though it is not really very much in the province of the Federal Government, is that we could use a great improvement in labor-management relations in this country, somewhat along Japanese lines, though I don't mean a literal imitation of what the Japanese do. I preach this idea to business and labor audiences whenever I get a chance, and I just want to mention it here.

In the U.S. context, I believe, improving labor-management relations will entail largely two things. One is more profit sharing, and the second is greater worker participation or employee involvement.

This last concept goes by a lot of names and takes a lot of forms. But the basic idea is a very simple one, which is to try to chip away, and in the limit, break down the we/they relationship that so often poisons labor-management relations. It's "us against them." That is not the attitude in a Japanese business, of course. There, it's "us," the labor and the management, against "them," the competitors. That is a typical attitude in many Japanese businesses and also in some American businesses, but not nearly enough. However, as I said, it's not obvious that there is anything very much for the Federal Government, as opposed to the private sector, can do about it.

Finally, let me touch on the deficit because you asked about that explicitly, and of course it's on the Congress's mind quite a bit. What's the role of the deficit in all this? Well, in the short run, the role of the deficit is, as I mentioned before, that it has effectively paralyzed the fiscal stabilization arm. I guess I don't need to repeat that any more. In the longer run, it has done several things, all of which I think have done the Nation no good. The first and most obvious is that, from my point of view and the point of view of most economists, the very perverse mix of monetary and fiscal policy that we've had for much of a decade has led to high real interest rates, which creates a bad climate for investment and therefore has impeded capital formation.

Now, I think that's very far from the whole story of why our productivity growth has lagged. Some people exaggerate the amount of productivity growth that you could possibly get from a speedup in capital formation. Nonetheless, the argument is qualitatively correct and no doubt has played some role. It goes some way, though I think not very far, to explaining why productivity growth in this country has been smaller than it has been in, say, Germany and Japan.

A second very corrosive effect of the deficit is that I think it has given us, as a Nation and especially the Federal Government and the citizenry behind the Federal Government, the view that we can't afford anything. So, if you mention, well, we have to do such and such for education and we have to do such and such for public infrastructure, not to mention we have to do such and such for foreign aid, one of the first reactions you get from people in the Congress and from the public, is: "We don't have any money. We can't afford that." I think this attitude has had a very corrosive effect in many, many dimensions.

And the final point, which is really a corollary to this point, is a specific dimension in which this attitude has had a corrosive effect: the fixation on the annual deficit has created a very severe sort of myopia which leads to—and this wraps up what I just said—a Federal Government policy that tends to stint on public investment broadly construed.

I mean by that, literal physical investments in infrastructure, but I also mean investments in education, and I also mean investments in the early intervention programs that I mentioned before. I use the term "investment," in the economist's sense, as anything that costs money up front and pays you back later. The obvious effect of such investment is to raise the current deficit and lower future deficits.

Well, that looks like a very bad political bargain to incumbent members of Congress, and indeed it's sometimes banned by Gramm-Rudman and other similar pieces of legislation. But it leads the Congress and the public to ignore or fail to fund programs that offer very, very high, future paybacks but which do have up-front costs. Public infrastructure and early intervention programs will indeed raise the deficit in the short run. I think this last item is a somewhat neglected but to me a very major cost of the budget deficit. Why don't I stop there.

Representative HAMILTON. Thank you. That's a good start.

In the very short term here, you think we are coming out of the recession.

Mr. BLINDER. Yes, almost definitely.

Representative HAMILTON. Keep recovery on track, you said, instead of getting recovery.

Mr. Blinder. Yes.

Representative HAMILTON. And fiscal policy you don't see playing much of a role. You would ease on the Fed, the monetary policy and the interest rates very modestly or even more.

Mr. BLINDER. Yes.

Representative HAMILTON. Now, when you get into the question of growth, you call for a lot of additional spending—public spending—but you want us to keep the deficit agreement in place.

Mr. BLINDER. Yes.

Representative HAMILTON. How do you do that?

Mr. BLINDER. Well, the first thing, since I never run for office, is that I would raise taxes.

Representative HAMILTON. You would raise taxes?

Mr. BLINDER. Yes.

Representative HAMILTON. What taxes would you raise?

Mr. BLINDER. Oh, it has gotten to the point where I hardly care any more. But I think I would first raise the personal income tax.

Representative HAMILTON. And you would raise it how much?

Mr. BLINDER. Enough to bring in $50 to $75 billion in revenues, something like that.

Representative HAMILTON. It would be a few percentage points.

Mr. BLINDER. Yes, it would be a couple. I don't know exactly. Yes, that's right.

Representative HAMILTON. And, of course, that sends a lot of people into a tizzy.

Mr. BLINDER. Oh, yes, absolutely.

Representative HAMILTON. And they argue, of course, that you will destroy investment and all that.

Mr. BLINDER. Sure. They argue a lot of silly things.

Representative HAMILTON. That's silly; is that right?

Mr. BLINDER. Yes. We had higher investment to GNP ratios, as you know, in the high-tax years of the 1970s.

Representative HAMILTON. So, investment has gone down with the lower tax rates.

Mr. BLINDER. Well, it hasn't changed——

Representative HAMILTON. It hasn't changed that much.

Mr. BLINDER. It depends on whether you look at gross or net investment. I like to look at gross, and it hasn't changed very much as a share of GNP.

Representative HAMILTON. So, you think then that a modest income tax rate increase, and using the proceeds from that in the areas that you indicated—education and infrastructure—basically is the way to get long term——

Mr. BLINDER. It would almost certainly be pro-growth strategy. You could add energy taxes to the list also.

Representative HAMILTON. All right.

Mr. BLINDER. I should say if I thought there was any chance that the Congress would go for a really big increase in revenues, then I think I might talk about a consumption tax or a value-added tax. But I don't think it's worth the political, social, not to mention, administrative upheaval to change the tax system that dramatically, if we're talking about $50 billion of revenue.

Representative HAMILTON. If you prefer, why would you prefer the consumption tax over an increase in the income tax rate?

Mr. BLINDER. Only to the extent that there is truth in the argument that it's more pro-investment and pro-saving than an income tax. I tend to be relatively dovish on that argument, and I don't think it's as important as some people do.

Representative HAMILTON. But increasing the consumption taxes hits the lower income people more, doesn't it?

Mr. BLINDER. Yes. That's one reason why I shy away from it. You need to put in some sort of large exemption. Yes.

Representative HAMILTON. On the labor-management relation business, you talked about profit sharing and worker participation. Do you think the enormous gap in the CEOs' income and the fellow out on the plant floor makes an impact on this relationship?

Mr. BLINDER. I suspect that it may. There isn't any real hard scientific evidence that I know of on that, and it would be hard to gather. But it is a fact, as you probably know, that over the last decade the gap between the CEOs' pay and the ordinary workers' or the entry level pay has risen quite substantially.

It's also fact that, relative to ordinary workers, CEOs get paid quite a bit more in the United States than almost anywhere else in the world. And the only reason for saying almost is that there may be some country, like Abu Dhabi, where this is not true. But as far as I know, it's true in every country—and usually by a large margin.

Now, the free market economist's view is going to be: If that's what the market is paying CEOs, that must be their marginal productivity. And it's not hard to imagine how a good decision by the head of a very large company could raise the company's profits by a hundred million dollars. So what if the CEO gets two million dollars.

But I think a powerful counterweight to that argument is to look at what CEOs get paid in Germany and Japan. What could there be different about the technology of capitalism in America and Japan to rationalize American managers getting five to ten times the wages of Japanese or Germans?

Representative HAMILTON. There haven't been any serious studies of that gap impacting productivity?

Mr. BLINDER. Not that I know of. There have been some studies of the size of the gap but not of the question you cited, so far as I know. It's a good question.

Representative HAMILTON. My own experience is interesting here. I talked with the CEOs, and they honestly do not believe that their compensation levels impact morale on the floor of the manufacturing plants. Now, I also talked to the people that are out on the plant floor, and they are mad as hell about it. I mean, it is a point of real anger with them. Now, it may or may not reflect in their productivity rate, I don't know.

Mr. BLINDER. It's hard to know.

Representative HAMILTON. But it is not correct to say that the people out on the floor don't know about it.

Mr. BLINDER. Oh, yes.

Representative HAMILTON. Or that they are not concerned about it. If anybody makes that statement, I don't think they're correct.

Well, let's see. One of the goals that has been introduced here in legislation is zero inflation.

Mr. BLINDER. Yes.

Representative HAMILTON. And it has the endorsement of Mr. Greenspan. What do you think of that as a goal of economic policy—no strike "a". It would be the goal of economic policy.

Mr. BLINDER. Well, starting with striking the "a," I think that's absurd. If there is going to be a single goal, it's hard for me to imagine a worse one. If you ask an easier question—should it be one of the goals?—I still don't think it should. I think that if we had a magic wand that could wave it to zero, I would wave it. It would be better to have zero percent inflation than 4 percent. But one never wants to forget the cost of getting from here to there.

Let's say we're sitting now with a 4 percent baseline rate of inflation, roughly. To get from 4 percent to zero, you'll have to put the economy through roughly two-thirds of what it took in the early 1980s to get us from 10 percent to 4 percent. That was a six-point reduction. I, for one, don't want to go through two-thirds of that again, and I fail to see what the great benefits are. Indeed, I think elements of a cogent argument can be made to the effect that a little bit of inflation is good for us.

Representative HAMILTON. You emphasize getting productivity up, long-range growth up, the importance of public investment in infrastructure and also public investment in worker education and training. Between those two, do you make a distinction as to what is more important?

Mr. BLINDER. I doubt there is any blanket answer to that. If you look at the possible physical infrastructure investments that are available, there is a whole range. Some look to be urgent and to have very high payoffs, and then you move down to less urgent things. Exactly the same will be true of investments in worker training.

Representative HAMILTON. What about public versus private investment?

Mr. BLINDER. I think there is at least some evidence—it's highly controversial, but I find it somewhat persuasive—that at this point in history in this country the returns to more public investment are likely to be higher than the returns to private.

Representative HAMILTON. I have a bell here to vote. Rather than hold you, I think I had better conclude, although I would like to keep it going.

The prescription you have laid out is your prescription for getting productivity up; is that right?

Mr. BLINDER. Yes, absolutely, and doing so without worsening the income distribution.

Representative HAMILTON. OK. How much of a consensus would that represent within the economics profession?

Mr. BLINDER. I think it's reasonably strong, with two exceptions. One is that some would say that I overestimate the role of public infrastructure capital. Probably, some economists, but a small minority, would even almost zero that out and say that it's not the thing to do. But that's a minority. But a number would say that I have overestimated the role of public infrastructure.

Representative HAMILTON. If you look at our economic growth, we had very strong growth in the 1950s and 1960s, and it slows down in the 1970s. Why did it slow down in the 1970s?

Mr. BLINDER. As you probably know, as a result of many JEC hearings, nobody has a good answer to that. The explanation that says the infrastructure growth slow-down is a good explainer of the productivity growth slow-down is at least as good as any of the other explanations, and I think maybe a little bit better. So, that's one of the things that leads me to push that argument.

You asked about consensus. If you had a panel here of four others, the one other aspect I think I would be taken to task for, but which I'm prepared to defend, is very much downplaying the role of private capital formation. I think you could easily get other witnesses that would focus much more on the role of private capital.

Representative HAMILTON. And your overall view that the economy will do pretty well in the short run, by that you're saying that we'll get out of the recession, but we're not going to get out of this recession like we have in past recessions, are we, with very vigorous growth?

Mr. BLINDER. No, by no means.

Representative Hamilton. So, that's only pretty well, and it's terrible for the long run because we're not doing the kinds of things that you've prescribed here; is that right?

Mr. BLINDER. Yes, that is right.

Representative HAMILTON. And the wage levels and the standards of living of people will not go up very much?

Mr. BLINDER. That's right, and that's the other aspect in which we're doing terribly—the lagging wages—which, of course, are tied up with productivity growth and the very large surge in income and wage inequality that has happened in the last, say, 12 years.

Representative HAMILTON. So, when I talk to my constituents then, I can't be very optimistic to them about the future of the American economy, and the fact that their sons and daughters will have a higher standard of living then they have had, as has been true historically in our country. I can't be very optimistic about that if we continue present policies?

Mr. BLINDER. I think that's right. And the frustrating thing about this is that to turn some of these things around is not that big an expense in a country as big and wealthy as we are. I find it very frustrating that we can't find the will to do it.

Representative HAMILTON. To conclude, let me just ask you a broad question about economic statistics. How are they?

Mr. BLINDER. Oh, boy, that's a hard question. It's very variable.

Representative HAMILTON. The real question is, are they eroding? This is a JEC special interest that we've had. Are they worse today or better than they were 5 years ago or 10 years ago?

Mr. BLINDER. I think they are probably worse than they were 10 years ago, largely I guess because of cutbacks in some federal statistical collection programs. And maybe because of the growing importance of some phenomena that we never measured all that well, such as environmental decay. Some of the trade statistics have never been measured all that well, and we look at them a lot more than we used to.

In the area of labor statistics, for example, there are lots of things the BLS used to have for us that they don't have any more. The quality of what the BLS does is still, I think, excellent, however.

Representative HAMILTON. Well, I apologize for breaking off the hearing. I have a whole list of things I would like to go into with you, but I just can't do it, and I'm sure you're short, too.

Thank you very, very much. I appreciated that book of yours very much. It was written so that even those of us that aren't economists can understand. And we're very appreciative of your articles.

Mr. BLINDER. Thank you. It's a pleasure to be here.

Representative HAMILTON. It's good to see you. Thank you very much. We'll conclude.

[Whereupon, at 12:00 p.m., the Committee adjourned, subject to the call of the Chair.]

ROUNDTABLE CONVERSATION WITH WILLIAM NISKANEN ON THE STATE OF THE ECONOMY AND ECONOMIC POLICY

THURSDAY, SEPTEMBER 26, 1991

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

The Committee met, pursuant to notice, at 10:15 a.m., in room 2359, Rayburn House Office Building, Honorable Lee H. Hamilton (vice chairman of the Committee) presiding.

Present: Representatives Hamilton and Snowe.

Also present: Chad Stone and Paul Taylor, professional staff members.

OPENING STATEMENT OF REPRESENTATIVE HAMILTON, VICE CHAIRMAN

REPRESENTATIVE HAMILTON. The Joint Economic Committee will come to order. Today's is another in a series of conversations that the Joint Economic Committee is holding with prominent economists to discuss the state of the economy and economic policy.

We are pleased to have as our guest today, William Niskanen, Chairman of the Cato Institute. In the 1970s, he was Director of Economics for the Ford Motor Company. In the early 1980s, he was a member of President Reagan's Council of Economic Advisors. He is known as a strong advocate of limited government and reliance on the free market.

We are very pleased, indeed, to have you and we look forward to having a discussion with you. We proceed here quite informally, so what we would like you to do is just begin with a few observations on the economy; what you think we are doing right; what you think we are doing wrong; where you think the economy is. And we will proceed with questions and dialogue after that.

STATEMENT OF WILLIAM NISKANEN, CHAIRMAN CATO INSTITUTE

MR. NISKANEN. Thank you, Representative Hamilton.

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The single most important problem of the American economy is our unusual rate of productivity growth, low relative to our history, and low relative to that of other countries.

Let me start with some numbers and offer suggestions, at least, about why this happened and what we might be able to do about it. In the period from 1948 through 1973, output per hour in the business sector of the United States increased at a 3 percent annual rate, 1948 to 1973. In the years since 1973, productivity has increased at only a 1 percent annual rate.

Now, let me put those numbers in a somewhat different context. At the prior rate of productivity growth, productivity and our potential standard of living doubled in 24 years. At the present rate of productivity growth, output per hour will double in about 72 years—a dramatic change in the rate at which the economic well-being of the American population will increase.

Another way to show the effect of this change is, if the productivity growth of the quarter century from 1948 to 1973 had continued to date, real GNP now would be 40 percent higher than it is—more than enough to solve the problems of the deficit and taxes and all kinds of problems at the state and local level and of American families.

The problem of low productivity growth has been compounded by the fact that our major institutions have really not adjusted to that change. Households have tried to maintain the growth of spending by reducing their saving rate. Businesses have tried to maintain their level of investment by massive borrowing abroad. And the government, of course, has tried to maintain a growth of expenditures by moving toward massive, continuous deficits even in peacetime recovery years.

For nearly 20 years now, we have been in a period of unusually low productivity growth, but we are acting as if that did not happen. In other words, we are acting as if we are still in a high-growth period.

The international comparisons are no more encouraging. We don't have good, general productivity numbers for most other countries, but we do have quite good numbers on productivity in the manufacturing sector across countries. And if you look at U.S. productivity growth in the 1980s in manufacturing, relative to other countries, you find an interesting pattern. In manufacturing, productivity growth was unusually high in the United States in the 1980s; in fact, higher than in the prior period.

For all that, that was about midway among the industrial countries, exceeded by Korea, Taiwan, Japan, Britain, and even Italy; even though, as I say, the productivity growth in American manufacturing was, relative to our own experience, unusually high. And at the recent relative rates of growth of productivity in manufacturing in Japan, relative to the United States, productivity in Japan will double, relative to the United States in about 30 years.

Now, those are the kinds of numbers that bother me. We have had a dramatic drop in productivity growth. We don't seem to have adapted our consumption patterns in any of the major sectors of the economy to that reduction in productivity growth, and that has compounded the problem by greatly reducing our national saving rate.

The record, internal to this period since 1973, deserves attention, even though the overall productivity growth has been quite low, at about 1 percent a year. In the dreadful period from 1973 to 1980, productivity growth was about 0.6 percent a year; in other words, six-tenths of 1 percent a year. It was about 1.7 percent a year during the Reagan years. And it has declined absolutely for the past 3 years.

This becomes a special problem because of several developments in the world. The U.S. economy has become increasingly internationalized. During the past 20 years, for example, roughly this period since 1973, the trade share of our total output has doubled; a great many more of our industries are directly competitive, either as exports or competitive with imports in the international market.

That has a couple of implications. One is that it will be increasingly difficult for low-skilled people in a high-wage country to maintain their standard of living. That's true of low-skilled people in high-wage countries everywhere, but it has become a new phenomenon in the United States. For the first time on record, for example, in this period since 1973, the ratio between the earnings of college graduates and the earnings of high school graduates has increased, and it has increased rather sharply. There's been an absolute decline in the real earnings of new high school graduates and particularly of young high school dropouts, whereas the rate of growth of earnings of college graduates has increased in this period of time.

This is the first time in the period since we have had information on the distribution of income and earnings that we have had this increased spread between the earnings of skilled and unskilled people. That is very largely a consequence, I think, of two conditions. One is the increased role of trade in the American economy. In effect, the supply of low-skilled labor to the United States has become a worldwide supply now, rather than just a local supply, because of the increased openness of our economy to trade.

There's a second reason, I think, that has contributed to this condition. And that is that the absolute skill level of high school graduates appears to have declined since about 1963. We've had an almost continuous decline of the SAT scores, for example, from 1963 to date. In the latest year, 1991, the verbal score was the lowest on record and the math score was near the lowest on record.

The decline in productivity growth is a general problem. It is not specific to the fact that we are just now in the early stages of recovery from a recession. It has gone on for too long now to dismiss. We don't have a thorough understanding of why it's happened. But it means that we are at least on a very slow growth path in the United States, unless something else happens, unless we can do something to increase this growth rate.

Let me offer my judgment about what are the major conditions that have led to this slowdown in productivity. One, I believe probably the most important, is what I regard as the dismal performance of our public primary and secondary school systems. As I mentioned before, SAT scores have declined now for nearly 30 years, since 1963. Something like 25 percent of young people drop out of high school. Although the proportion of high school graduates who go to college has increased somewhat, roughly 25 percent of new college students now are required to take remedial courses on material that they should have learned many years ago.

And during the whole of the post-war years, we have increased real spending per student in the public school system at roughly 40 percent a decade, or roughly doubling every 20 years. And we have implemented basically all of the conventional reforms in the public school system—smaller class sizes, increased teacher salaries, more nonteaching personnel, a consolidation of school districts, and state equalization programs to finance the poorer school districts in the state.

Basically, the whole of the conventional reform agenda has been implemented in the public school systems. And what we've seen is a rough doubling of real spending per student every 20 years since World War II and, at least since about 1963, almost a continuous decline in student performance. And that has led to a situation where even high school graduates these days lack the skills for participation in a world economy, where in a high-wage country we have to have high-skilled workers to compete. And those of us who have been in management positions find that even very conscientious new employees have trouble following simple instructions, or making changes, or identifying spelling errors. And the consequence of that is that even skilled people now have to use more of their time performing routine low-skilled tasks.

Representative Hamilton. Bill, you know Congresswoman Snowe?

Mr. Niskanen. Yes, Hello, Nice to see you. We have a major problem with our public school systems. And I don't know of any way to maintain a first-rate economy with a second-rate labor force. But we've got a generation now of young people who will be in the American labor force for another 30 years. And that will be a drag on our productivity for that whole period of time, unless we can figure out a way of improving their skills by on-the-job training or by adult education. And it's critically important that the new generation of people—kids coming into the labor force—not be so similarly handicapped.

This is also the reason—the legitimate reason—for concern about the distribution of earnings and income in that we have had, really for the first time in record, a spread between the earnings of college and high school graduates. And so, our labor force is becoming increasingly bipolarized, as are our cities these days.

A second reason for the drop in productivity, and this is more specific to the 1980s, is that we've had a dramatic drop in our national saving rate, basically in every sector. In terms of our gross saving rate, a percent of GNP, it's dropped about 5 percentage points. Roughly a quarter of that drop is a decline in personal savings; roughly a quarter is a decline in business savings; and about half is a massive increase in the dissaving by the government.

That has, and will until that's corrected, reduce the gross level of investment by the United States. In the immediate period, the primary effect is that it has led to substantial borrowing abroad. We maintained a barely adequate level of business investment in the United States in the 1980s, but only by massive borrowing abroad.

The third problem is much more complex and a much more widespread phenomena, and that is, a massive politicalization of our economy in the form of the use of the courts, regulatory commission, and legislatures for a wider range of purposes and increasingly detailed regulations. We have had a deregulatory wave of the older forms of regulations, starting in the late 1970s and continuing through the 1980s. But all of the evidence in terms of indirect indicators is that the amount of regulation and litigation in our economy has continued to increase.

Property rights are much less secure in the United States than they were in the past. We've had any number of cases in which ex-post restrictions have been placed on property after the initial purchase of the property in the name of perfectly worthwhile objectives like historic preservation. People who have bought a piece of property have found years later that somebody has declared it an historic property and/or has restricted its use in the name of preserving wetlands. All kinds of people, tens of thousands of people, have found that property that they had purchased many years ago has been subject to restrictions on their use. We have, in effect, shifted the liability for Superfund to our insurance companies. This liability can be huge, maybe up to $500 billion. Insurance companies, at least according to the prevailing interpretations in the courts, are now liable for conditions on properties that they insured at a time when these conditions were perfectly legal.

As you know, we have had an explosion of product liability and malpractice insurance costs. Something like 95 percent of the wholesale price of Pertussin—the whooping cough drug—is to cover product liability. Something like 30 percent of the wholesale price of a standard step ladder is to cover product liability.

These are complex and fairly pervasive phenomena. I have been inclined, as have many economists, to use the relative number of lawyers in the United States as an index of this problem. I don't blame the lawyers for the problem in the sense that they are basically responding to the demands in our system. And I think that it would be an inappropriate conclusion to believe that somehow we ought to restrict the supply of lawyers.

But we do have, as Vice President Quayle pointed out, something like 70 percent of the world's lawyers. And we now have something like 750,000 lawyers in active practice in the United States. That is not so much the cause of the problem but is a reflection of the fact that we have become an extraordinarily litigious society, and one in which property rights are very much less secure than they have been. People are using the courts and regulatory commissions to basically acquire other people's wealth. And that, of course, provides an incentive for people to use the same process to try to defend themselves against these political raids on their wealth.

These are awkward problems to address. The Federal Government in many cases doesn't have a very clear handle on them. The Federal Government, I think appropriately, has a relatively limited role in education. The Federal Government is the primary contributor to the problem of low savings, but merely decrying the high deficit hasn't proved to be very effective in reducing it. And although the Federal Government, I think, has been the primary agent of the massive change in the role of litigation and regulation in our economy, again, there is no silver bullet that one can use to stop that process. And I wish that I had some fairly clear cut recommendations on the matter, but I'm compelled to warn you about it.

The immediate outlook for our economy is fairly favorable. I think that we will have a growth rate in the 3 percent range for the next year or two. And it will be clear that we're coming out of a recession. But over the course of the 4 years of the Bush Administration, we will have the lowest growth rate of any Administration since that of Herbert Hoover. And that's according to the Administration's own economic forecast.

And the longer term prospects are for quite slow growth. At least a significant part of the growth of real GNP in the 1970s and 1980s has been increased female labor force participation. I think that increase is likely to stop. I think that we have reached close to a maximum of the proportion of adult women in the paid labor force. And so, that source of growth of total output, I think, is going to stop. And without a growth of productivity and labor force participation by other groups, I think we may very well be in for something like a 2 percent real GNP growth path until these other situations are corrected. And that will mean a relative decline in our share of world output for as far ahead as we can see, compared to countries that are growing at a higher rate, which is most of the industrial world at the present time.

That is enough of a set of concerns. And I think it's best now to respond to particular questions.

REPRESENTATIVE HAMILTON. Thank you, Bill, for your comments. Let's just begin with a few questions. You said, I think, in your first observation that productivity growth was our most serious problem and elaborated on that. One of the things that is curious to me in the economic debate in the country is that we don't seem to focus on that very much. In political discussions and discussions of what we ought to be doing, even discussions among economists, productivity is so essential to economic well-being: why don't we focus more on the question of productivity growth or the lack of it in the country than we do? Why is that?

MR. NISKANEN. Well, I think most people try to speak up for the interests of their particular economic group. Most of the people you hear at congressional hearings are expressing concern about their particular industry, or their firm, or their labor group, or their region. And so, the focus has been on what they perceive to be a competitiveness problem, which is how competitive their firm, industry, region, or particular labor group is relative to other people. And that's a natural part of our political process, in that there are very few people who have an economic incentive to speak for the general interest as distinct from the interests of their particular group.

I think that the focus of the political debate on competitiveness, however, is really quite misleading and counterproductive. Any person, or any firm, or any nation can always make themselves more competitive by making themselves poorer. But presumably that's not what the game's all about. You can always lower your own wage rate to increase your competitiveness in the labor market. You can always lower the prices of your firm if you're willing to sacrifice profits and make yourself more competitive.

Now, what a lot of people try to do, of course, is to make themselves more competitive by restricting the other people's competition by entry barriers or trade restraints of various kinds. Now, of course, that makes somebody else poorer.

So, competitiveness is really the wrong focus for a number of reasons. Competitiveness doesn't make us richer. Productivity is the only thing that can make ourselves richer. And there isn't that much relationship between competitiveness and productivity. No nation, regardless of how hard it works, can be competitive in every product line. It's going to have some activities in which it has a comparative advantage, and others that it has a comparative disadvantage. And the competitiveness problems, for example, of the American textile industry are a consequence of the fact that other industries are more productive and that we're a relatively high-wage rate country. And in industries and firms where productivity is low relative to that of other American industries, they're going to have trouble because their wage rates will be more nearly determined by the general productivity patterns, but they're competing in a world in which other people's productivity is higher, relative to their wage rates. Or the inverse, the wage rates are low relative to their productivity.

We're going to have trouble competing in industries where the product can be made quite adequately by low-skilled labor, because low skilled labor in a high-wage country is going to be in trouble. And that means that we have to work on the skills. We shouldn't give up on this lost generation. We've had nearly 30 years of declining test scores. We should think about ways to encourage businesses to provide on-the-job training. We should think about adult education for vocational skills and retraining.

But, more importantly, we have to make sure that this process of decline in our public school system stops and is reversed.

REPRESENTATIVE HAMILTON. Turning this around, from your standpoint, productivity is a long-term effort. Now, you identified, when you were talking about how the slowdown in productivity is the result of the dismal performance of the schools, that that's an effort for decades.

MR. NISKANEN. A lifetime.

REPRESENTATIVE HAMILTON. Probably a lifetime. The national savings rate is another thing you put your finger on. That's exceedingly difficult to turn around, too, isn't it? I mean——

MR. NISKANEN. Well, at least there, the responsibility is fairly clear. The problem is——

REPRESENTATIVE HAMILTON. The responsibility is here.

MR. NISKANEN. Right.

REPRESENTATIVE HAMILTON. Washington. Let's talk a little bit about the national savings rate. What kind of things would you favor to get that national savings rate improved?

MR. NISKANEN. I am not an enthusiast for things like IRAs. IRAs, I think, have a questionable effect on personal savings rates. And to the extent that they reduce tax revenues, they probably reduce the national savings rate. So, I'm not an enthusiast for IRAs. After, hopefully in our lifetime, we solve the federal deficit problem, then we ought to be thinking about changes in our tax structure that will reduce the bias against different kinds of savings.

And ultimately, most economists would support moving more toward a consumption tax rather than an income tax. But my own view is that the priority is to get the federal deficit under control. On the federal budget accounts, it looks like now it's nearly 6 percent of GNP, and it's about 4 percent of GNP on the national income accounts. And that's the biggest part of the problem.

Now, saying that is not enough, of course, because we've known that for a decade. And all of us, one way or the other, have been a part of the problem. And we've got to figure out a way to reduce the federal deficit.

The drop in the business saving rate, I think, is not so much a matter of concern. One interesting thing that happened in the United States in the 1980s is that the relative price of business investment goods fell rather sharply. So, business was able to maintain a roughly average rate of real investment without saving as much. We haven't had a significant drop in the real investment rate, even though there's a big drop in the saving rate, because the real price of investment goods has fallen and we've borrowed substantially abroad.

Now, your letter asks whether we should reduce the deficit by spending cuts or tax increases. And I suppose you can predict my answer. But I think we ought to reduce the deficit almost entirely on the spending side. And let me give you the reasons for that conclusion. The marginal costs to the economy of an additional dollar of tax revenues right now looks like it's about $1.50. In other words, the amount of economic output displaced by an additional dollar of federal tax revenues looks like it's about $1.50. And the reason for that is just the misallocative effects of taxes. And that ratio would be a lot higher if we didn't have the 1986 Tax Reform, which made the misallocative costs of our federal income tax much lower. But it is still moderately high. It's like a dollar and a half per dollar of federal tax revenues.

And that suggests we ought to have a quite high threshold for approving federal spending programs. In other words, only things that are worth more than $1.50 per dollar of spending are really worthwhile financing because of the indirect effects of taxes on economic growth. So, we ought to have a quite high threshold for approving federal spending.

Second, is that we have had a massive, dramatic political change in the world. The Cold War is over. The Soviet Union still has a lot of nuclear weapons, but it is no longer a military threat to Europe. And we have yet to see any peace dividend. And my own views—contrary to that of a lot of my conservative friends—is that we ought to be thinking about a dramatic reduction in the real defense budget, probably reducing it by half by the end of the decade. I would favor setting a target of something like $150 billion for the defense budget in 1991 dollars by the end of the decade.

Now, the problem of our current defense budget, as I'm sure you know, is that we're going to have a massive reduction of forces whether or not we have a reduction of the budget, because the defense budget is internally inconsistent. The current defense budget in real terms cannot maintain the current force structure, given the extremely high priced weapons systems that are coming down the line. So, even if we don't cut the defense budget, we have to have a major reform in the defense program. But we have to do better than that because that is not generating any peace dividend.

And there are lots of other elements of the federal budget that I would get at, and the sooner the better. And I'm pleased to respond to questions on that. But my general answer is that we should not think about additional taxes as the primary means of reducing the deficit. We should be doing it primarily on the spending side. And from my point of view, the focus should be on three areas: defense, medical care and agriculture.

REPRESENTATIVE HAMILTON. Olympia, do you want to go ahead?

Representative Snowe. On the defense question, would you have felt this way prior to unraveling of the Soviet Union? Secretary Cheney suggested the reduction over 3 years. And you do not think that is enough?

MR. NISKANEN. The major change is that the Western security frontier has moved about 500 miles to the east. That happened 2 years ago. The subsequent changes in the Soviet Union have, I think, only reinforced that situation.

Last night I had discussions with the leadership of the Ukraine. Without exception, they all talked about the Soviet Union in the past tense, without exception, including their foreign minister. Roughly, half of the defense budget now is to pay for our NATO commitment and not strategic problems and problems elsewhere in the world. And I think that the potential of a Soviet conventional threat against Europe now has gone to close to zero. And I think that we ought to move very quickly to change the defense budget in response to that.

Now, conditions elsewhere in the world—I think we're going to be kicked out of the Philippines. I think we ought to take advantage of that to declare victory and go home. I think we ought to seriously consider major reductions of our forces in Korea and Japan. The change in the world is enormously beneficial in reducing the risk of war and particularly of nuclear war. It will also have some other implications for us, and we'll have to think them through. Our leverage, for example, on the European community has been and will be dramatically reduced. And the potential for us, more or less, dictating the terms of GATT and other international arrangements, has been dramatically reduced, because these countries are much less dependent upon us for a security guarantee than they used to be.

So, we are going to have to be dealing with friends in a rather more controversial and confrontational way than has been the case in the past. It is not incidental that the Uruguay Round has broken down, because they are very much less dependent on us than they were in the past on other matters. So, there are things that we have to adjust to. But one of the adjustments that we should make is to recognize that the rationale for roughly half of our defense budget has disappeared, and that we, at a minimum, ought to make the adjustments that are consistent with that condition.

Representative Hamilton. One of the reductions you mentioned was medical care. That caught my ear because the pressures are just enormous that produce increased expenditures on health care. I would like you to elaborate on that a little bit. Are we to cut back?

Mr. Niskanen. The way we ought to cut it back, and I think that it is at least within the realm of the politically feasible, is to move to an income-tested deductible, and at the same time, expand and broaden the program to basically everybody. An income-tested deductible would transform our public medical insurance from basically a pre-payment system for most care to something closer to a catastrophic system that would be extended to everybody.

We have a provision in our tax code that I think provides an interesting number and concept. In our tax code, for example, medical expenses are not deductible until they are over 7.5 percent of adjusted gross income. We could apply that same standard to any publicly provided insurance. If, say, that somebody's annual income was $10,000 a year, we'd pay the first $750 on their own and then would be insured at a high rate above that. Whereas somebody's whose annual income is $100,000 a year would pay the first $7,500 on their own and then would be insured by a co-payment rate above that.

There is a reasonable case that you might want to make some minor modifications to that, something like one free physician's visit a year for everybody, just to encourage them to have a periodic check-up, and maybe more extended physicians' coverage for pregnant women and women with very young children. There are some minor modifications you might want to make to this basic approach. But the general concept of an income-tested deductible would permit both the reduction in spending and a broadening of coverage.

Now, if people wanted more insurance than that to cover the first 7.5 percent of their income, then they can augment that with private insurance. But the public insurance would be limited to major medical events and not to routine coverage, which it is right now. It is inappropriate to regard most current medical insurance as insurance. It's really a prepayment system, not insurance. You have people in quite different risk categories thrown into the same premium pool, which is really inconsistent with the whole concept of insurance. And it makes no sense that insurance cover eyeglasses, most dental care, back rubs, and so forth. That's really absurd.

So, I think that there is an important change that could both respond to what the new demands are, which is mostly covering people who are not covered at all. It's the uninsured, the 30-some million people who are uninsured, that is, at least the rationale for most of the new demands, and start to rationalize our medical insurance system.

Let me give you a sense of what's happened since 1965 when we embarked on Medicare and Medicaid. The relative price of medical services has increased roughly in proportion to the amount of insurance coverage. Now, we've had a dramatic increase in the shared medical costs, paid by both public and private insurance in this 25-year period. So, the proportion of costs covered by insurance has greatly increased. But the amount that is not covered by insurance is a higher portion of personal income than it was at the beginning of the period because of the dramatic increase in the price of medical services.

So, in some sense, we're paying a lot more and getting less because the effects of the insurance have fed back into the price of medical service. So, we're in an unstable situation. Nothing can grow faster than GNP forever. And, of course, medical care now costs nearly 12 percent of GNP in the United States and is rapidly growing. And the price of medical services has been increasing at two to three times the general inflation rate. So, I think broadening insurance coverage without reforming insurance is a disaster, just the wrong approach. The political price of broadening insurance—of responding to those who are demanding a broader insurance coverage—should be a major reform in the structure of our public insurance programs.

Representative Hamilton. Have you costed this out, your concept here of medical care?

MR. NISKANEN. I have not done it. The direct cost is fairly easy to cost out if you just look at the income distribution and say, nothing below 7.5 percent. That's a fairly straightforward costing exercise.

The more important part of it is the effect on prices of medical services, in that you would have, I think, a dramatic reduction in the inflation in the medical services.

REPRESENTATIVE HAMILTON. And in agriculture, you would go to a market economy?

MR. NISKANEN. Our agriculture program is absurd. It's based on the Agricultural Adjustment Act of 1937. It's basically a New Deal perspective. We have the most productive agriculture in the world, with the exception of a few sectors like sugar and dairy. And to spend tens of billions of dollars to subsidize American agriculture is a political crime.

One of our associates has recently published a book on this matter. Jim Bovard writes very forcefully and he's also right.

[Laughter.]

MR. NISKANEN. You may represent an agricultural district. I have a basis for optimism that we can sort out this problem. But, you know, only about 2 percent of the American labor force is in agriculture these days.

REPRESENTATIVE HAMILTON. Yes.

MR. NISKANEN. And you probably have a better explanation than I do of why they seem to have such clout in Congress. I don't have a very good explanation. It must be that there are more people whose grandfathers were farmers than there are people who are farmers now and have some kind of nostalgia about it.

REPRESENTATIVE HAMILTON. It's a phenomenon worldwide, actually.

MR. NISKANEN. Well, it's a phenomenon in the rich countries. The two patterns in agriculture in the world is that rich countries subsidize their agriculture and poor countries exploit their agriculture. Most of the poor countries, for example, massively exploit their farmers by having state marketing boards, forcing farmers to sell to state marketing boards at artificially low prices. And so we have this tragedy of the exploitation of farmers in the poor countries, and a different and rather lesser tragedy, but still an expensive one, of massive subsidies and protection of farmers in rich countries.

REPRESENTATIVE SNOWE. Do you agree, Bill, with the Administration that the recession is over?

MR. NISKANEN. Yes, the recession is over. And I think the strongest signal of that, probably the most reliable leading indicator, is the yield curve. The ratio of long rates to short rates is——

REPRESENTATIVE HAMILTON. The what curve?

MR. NISKANEN. The ratio of long interest rates to short interest rates is probably the most reliable leading indicator of change in GNP growth. A flat yield curve, or an inverted yield curve, is almost always followed by a recession. And a sharp yield curve with long rates, high relative to short rates, characteristically proceeds relatively high economic growth.

We have a relatively sharply yield curve right now. Short rates, Treasury bills are about 5 percent and long-term government's close to 8 percent. And that situation gives me confidence that the general recession is over, although real estate prices in New England may continue to drop. But there will always be regional differences.

REPRESENTATIVE SNOWE. What accounts for the difference in the 1982 recession and this one, in terms of how we emerge from the recession? I mean, you said that you were using 3 percent for next year. How does that compare?

MR. NISKANEN. The first 2 years of recovery from the 1982 recession were about 6 percent growth.

REPRESENTATIVE SNOWE. Six percent.

MR. NISKANEN. Right.

REPRESENTATIVE HAMILTON. Usually, when we come out of a recession, we come out pretty strong.

REPRESENTATIVE SNOWE. And we're not going to this time.

REPRESENTATIVE HAMILTON. Yes, and this one seems to show much less growth.

REPRESENTATIVE SNOWE. Why is that?

MR. NISKANEN. The recession wasn't as deep for one thing. And typically the strong growth rates in the early recoveries have followed the deepest recessions, like the 1974-75 and 1981-82 recessions.

A second is that we're on a low-growth path. Because of all these productivity problems that I've talked about, we're on a low-growth path. And the productivity problems, I think, are compounded by two or three developments in labor force. The rate of increase of female labor participation is slowing, and I think might come to a stop. And that's accompanied by a condition that I regard as a national tragedy, that the age of retirement by adult white males is continuing to drop. And that's been the case for about 40 years. We've had really a dramatic reduction in the average age of first retirement by adult males, white males, particularly.

REPRESENTATIVE SNOWE. You'd think the longevity——

MR. NISKANEN. You'd think it would work the other way.

REPRESENTATIVE SNOWE. Yes, the reverse of that.

MR. NISKANEN. No. The proportion of our population that has retired has increased for two reasons. One is that the number of years of remaining life after age 65 has increased, and the number of years of retirement before age 65 has increased. And so the retirement population has increased rather dramatically. And I find it a tragedy to recognize that some of my high school and college classmates have retired, people in perfectly good health. I'm not envious about them. In fact, I don't envy them a bit because I can't imagine retiring. But when I hear that——

REPRESENTATIVE HAMILTON. A lot of people out there think they ought to be able to retire at 50 and 55. You run into that all of the time.

MR. NISKANEN. But when I hear that friends of mine—high school and college classmates of mine—have retired, I've regarded it as a tragedy and not something that anybody should prefer.

REPRESENTATIVE HAMILTON. Let me pick up on your third reason why productivity has slowed down, which I think you'd describe generally as kind of a politicalization of the economy. And you talk about the courts and regulation. We've been through a period of deregulation; beginning in the late 1970s or early 1980s, we deregulated banks, railroads, telecommunications, and all of these things. And I'd like to get your assessment of what has been the impact of that deregulation. Was it genuine deregulation? How should we continue that path to suit your view?

MR. NISKANEN. First, we should recognize that the major deregulatory efforts of the late 1970s and 1980s were of the older forms of economic regulation, regulations of prices and entry, many of which have been in place for 100 years, since the ICC was created, for example.

My sense is that, without exception, those types of deregulation have been net benefits. That's quite obviously the case in, say, airlines, trucking, railroads, and communications. The situation of the S&Ls is more complex because we deregulated deposit rates without changing deposit insurance. And in two areas, we didn't deregulate very smartly. One is airlines and one is banks. In airlines we deregulated price and entry in the domestic commercial aviation. But we still have basically a socialized and unduly rigid and technologically backward airways and airport system. We haven't built a new airport for 15 years, at a time when the number of flights has increased 60 to 70 percent. So, we've had an unresponsive airport and airways system, faced by a dramatic increase in flights that is a consequence, in part, of deregulation.

So, we did one thing right, but we didn't do the complementary thing that would have been necessary to avoid the increase in congestion and delays at our major airports. We still haven't been willing to use congestion fees, for example, to ration demands at our major airports. Our airways system—the FAA controlled system—is a decade behind the technology now available to the military. We've accumulated money in the airports' trust fund without building very many new airports. So, that was a situation where we didn't follow up the deregulation of the airlines with the other governmental responsibilities in that business.

And much the same story about the S&Ls and the commercial banks. In 1980, the last year of the Carter Administration, the deposit rates controls were ended. And that was a correct decision. It was necessary to avoid a run on the banks because people were taking the money out of bank deposits and putting them in money market mutual funds, where the rates were already deregulated or had never been regulated. And so that was the correct action. What was not right is that we deregulated the deposit rates without changing deposit insurance. Now, the problem of the savings banks——

REPRESENTATIVE HAMILTON. We should have decreased the deposit rates.

MR. NISKANEN. We have to greatly restrict deposit insurance and possibly risk-rate premiums and all kinds of things. And we still haven't done it. FIRREA, for example, basically doesn't touch deposit insurance yet. And even the study that FIRREA mandated, that the Treasury was supposed to do in 18 months, which is supposed to be addressed primarily to deposit insurance, finally came out and had some good recommendations in it for the general structure banking regulation. But, by and large, this study still doesn't touch the deposit insurance issue.

The S&Ls had special problems. The S&Ls were under water in 1981 by any kind of market-based accounting, before the recession of 1982 and before there was any significant increase in deposit rates. And that was basically because the rates they were already paying on deposits were higher than the rate they earned on old mortgages. You know, you can't have an old mortgage portfolio of 5 percent mortgages and have to pay 10 percent on deposits and expect to survive.

So, we didn't do some important things to complement the deregulation that took place in the late 1970s and 1980s. It's important to recognize, as I'm sure you do, that this was a bipartisan movement to deregulate these older forms of regulation. And in fact, the major part of the work was done by Congress during the Carter Administration, with the support from both parties and also opposition from both parties. The deregulation movement should not be thought of as being specific to the Reagan Administration. The Reagan Administration did not do some things that they should have and that has caused some problems.

But at the same time, for example, both in the 1970s and the 1980s, the amount of other kinds of regulations have increased rather dramatically. The cost of environmental regulation, for example, is now about 3 percent of GNP. The best estimate was that it was 2.6 percent of GNP in 1985, and the new Clean Air Act will add about a half a percent of GNP to the aggregate cost of environmental regulation.

REPRESENTATIVE HAMILTON. Do you make this distinction, as often made in economic regulations? On the one hand, you ought to proceed with deregulation in that area, but social regulation on health, safety, and environmental matters, you might have to tighten? We hear that quite a lot.

MR. NISKANEN. There's more reason for an appropriate government role in the areas that we call social regulation. But the nature of those regulations, I think, is dramatically inefficient. And, in addition, in many cases, we should be using the budget rather than regulation to accomplish these goals.

Let me give some examples on, say, historic preservation and wetlands; very controversial issues right now. And if either party doesn't think through these issues, there's going to be a massive outrage by a lot of small property holders. What has happened in both those areas is that the governments have imposed ex-post constraints on the use of property after a person has bought it, in the name of preserving historic properties and wetlands, and saving endangered species and all that; the whole bit.

From both a legal and a fairness point of view, there ought to be recognized as a partial taking of property rights. The courts have been slow moving to respect partial taking. In other words, requiring their 5th Amendment protections on partial taking. And that's a move by the courts that I applaud. And if we recognized that what we were doing, in effect, is that we were taking away property rights that people had acquired at a time when these were perfectly legal activities, we should recognize that in most cases of that nature we should use the budget rather than use regulation to accomplish what I think are wholly valid purposes. I favor a certain amount and certain types of efforts for historic preservation, wetlands, endangered species, and the whole bit. But I think it would be far preferable if we used the budget to buy easements from people rather than, in effect, taking the easements without compensation. And for two reasons: one is that we will make more efficient decisions if we actually have to put up some money to buy the easements rather than just taking them; and two, there's a terribly important fairness issue involved here. Somebody who owns a piece of property that he had a plan to develop in a particular way and the Corps of Engineers comes by and says, I'm sorry, I've just declared your property to be a wetland.

Representative Hamilton. And the government ought to compensate.

Mr. Niskanen. And if it is important to preserve that particular area as a wetland, the government ought to buy the easement for it to preserve it in that particular form. You don't have to take full title, but you can buy an easement that would be sufficient to protect whatever it is that the general public values.

So, even in the social area, where there is a more legitimate basis for government regulation, and maybe as our general income grows, hopefully, the demands for environmental quality and safety and so forth will continue to increase, as they should. But we ought to be using dramatically different kinds of regulation. And in many cases we ought to be using the budget rather than a regulation to accomplish these ends.

Representative Snowe. Bill, you were talking about the uneducated work force. It is true if you look at Japan that they have the best educated lower half of the work force, and that is the problem that we are facing in this country. What can we do at the federal level, even though the state and local government play the primary role? The America 2000 Initiative, making sure that by the year 2000 we establish the goal that everyone graduates from high school; second, concentrating in science and math——

Mr. Niskanen. Right.

Representative Snowe. Do you think that's a way in which we can help to at least funnel some federal dollars for incentives for helping state and local governments? It is a concern if you look at the disadvantaged in our society, those kids who are at risk in our school systems.

Mr. Niskanen. Right.

REPRESENTATIVE SNOWE. If we don't get them early on—that is why the Head Start is so effective—these pre-school programs—if we don't get these young people early on, they will become a statistic ultimately.

MR. NISKANEN. My sense is the most important things the Federal Government can do are of two kinds: One is to use the fact that it's the federal budget that provides most of the loans and scholarships for higher education—to use that as leverage on the performance of the primary and secondary schools. And the one most glaring omission in the Bush package is that he did not propose that, say, Pell grants and student loans be tied to performance on tests. He proposed a national testing program, but he did not give anybody any incentive, either individually or as a school system, to perform well on the tests.

Now, there's reason to be concerned about having mandatory tests. But if the Federal Government and you people will have to defend the grants and loans to higher education, I think you ought to be in a position to put a condition on eligibility for those grants and loans. And what I would do—and this was the recommendation of Bob Samuelson, the economist journalist, who had a very effective column on this matter—is to establish a certain standard of performance on these tests as a condition for the Pell grants and student loans, and then raise that standard slowly over time. If you just put the money out there and then say we also ought to have a testing program but have no linkage between the two, one, people are going to resist the tests, and they're going to regard the loans and grants as entitlements rather than something they earned.

So, I would suggest putting a link between those parts of the Bush plan. Say that we're going to institute a national testing program; you don't have to take the test if you don't want to, as an individual or an individual school. But if you want to be considered for student loans or for Pell grants, you not only have to take the tests, but you have to perform at a certain level on the tests. And then over time we're going to increase that standard.

That's the single most important leverage that you're going to have on the system. You can pour money in at the bottom end of the Head Start system. And what you'll find is that the gains during Head Start will dissipate over the course of their experience in the public schools. By the time they graduate from high school, if they do, you won't be able to find a big difference between Head Start kids and kids who don't get a head start, even when standardizing by family background.

So, putting money in at the bottom without some kind of system that pulls them through the top isn't going to have a high payoff. So, that's going to be the primary leverage of the Federal Government, the one most glaring omission in the Bush package. Now, there are lots of other elements in the Bush package that are for show, you know, your 535 magnet schools and so forth. I think the number is not accidental.

The other thing that we ought to do is to sort out the law as it bears on the use of public money in private schools. The distinctions in the law right now are quite contrived and I think won't stand up to any kind of

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inherent reasoning. But they're a big block. For example, for the whole of the post-war years, we have been willing to make scholarships and loans and public monies to institutions of higher education, even if they're church related. The GI Bill and all kinds of student loans and grants can go to higher education schools. For all kinds of NSF money—NIH money and so forth—we don't ask whether Notre Dame is a church-related institution or not when they apply for NSF money or NIH money, and we don't put restrictions on the use of grants and student loans if they go to a church-related, private institution at the higher education level.

We've also allowed very limited forms of public money to go to church-related primary and secondary schools for school busing, loans of textbooks, and things like that.

REPRESENTATIVE HAMILTON. Lunches, yes.

MR. NISKANEN. But we still have this idea that there shouldn't be any public monies going to serve general support of private schools, and particularly to church-related private schools at the primary and secondary level. I think that's wrong. The new Coleman studies of the 1980s, which have focused primarily on the relative performance of Catholic and public schools, tell a very dramatic story in two important dimensions. One is that in his sample of private school students, mostly Catholic, they seem to advance one grade, relative to the public school students between the sophomore and senior year in high school. And that's an advance within a three-year period of one grade, the difference between private and public schools—with the most careful kinds of statistical controls on family background and so forth.

Second, our private schools in this country are more integrated than the public schools. That doesn't show up in the aggregate data because, on the aggregate level, the proportion of different minority groups in the public schools is closer to that of the population. But the individual public schools are more segregated than the individual private schools. You're more likely to go to a nearly all-white or nearly all-black school in the public school system than you are in a private school system. It's that the Catholic schools and most private schools have a student body that is closer to our national composition than do our public schools.

So, we ought to bite the bullet and say schooling is very important, and it's a tragedy to see good Catholic schools close in Washington, Philadelphia, New York, and Chicago when their spending per student is half or less than that of the public schools in the same area. And they provide better education but, given the student body they attract, you can't get that many more student families to pay both their taxes and the additional tuition of the private schools. We're losing schools in the private sector that are better, both in student performance and expenditures, than the public schools that they're competing with because of basically the double price that parents have to pay to have their kids in those schools.

REPRESENTATIVE HAMILTON. Bill, I appreciate that. I've run out of time. I have to go. Olympia, do you want to say anything?

REPRESENTATIVE SNOWE. No.

REPRESENTATIVE HAMILTON. We're very grateful to you. I've got 30 or 40 other questions I'd like to ask.

MR. NISKANEN. We'll do it again some time.

REPRESENTATIVE HAMILTON. I'd like to try to extend it, but it's been a very good morning. Thank you very much for coming. And we stand adjourned.

[Whereupon, at 11:27 a.m., the Committee adjourned, subject to the call of the Chair.]

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

THURSDAY, OCTOBER 10, 1991

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

The Committee met, pursuant to notice, at 9:38 a.m., in room 2359, Rayburn House Office Building, Honorable Lee H. Hamilton (vice chairman of the Committee) presiding.

Present: Representative Hamilton

Also present: Charles Stone, professional staff member.

OPENING STATEMENT OF REPRESENTATIVE HAMILTON, VICE CHAIRMAN

REPRESENTATIVE HAMILTON. The Joint Economic Committee will come to order. Today's is another in a series of roundtable conversations that the Joint Economic Committee is holding with prominent economists to discuss the state of the economy in economic policy.

We are pleased today to have as our guest, Paul Krugman, Professor of Economics, Massachusetts Institute of Technology. Among his colleagues, Professor Krugman is known for highly innovative work in the theory of international trade.

For the rest of us, Professor Krugman has written a highly readable and accessible book, *The Age of Diminished Expectations, U.S. Economic Policy in the 1990s.*

Now, Professor Krugman, we're very pleased to welcome you. We look forward to our discussion with you. I think, as you've probably been advised, we'd like you to begin with just a few observations, if you would, about how you see the economy at the moment and, most importantly, what you think we ought to be doing—both at the short-term and long-term timeframe.

Representative Hamilton. You may begin with whatever observations you think appropriate.

STATEMENT OF PAUL KRUGMAN, PROFESSOR OF ECONOMICS, MASSACHUSETTS INSTITUTE OF TECHNOLOGY

Dr. Krugman. Thank you.

As I understand it, I should really talk quite briefly and then let this open up, because I'm not entirely sure I know what your interests would be. But let me just say a few words.

There are really two kinds of issues in economic policy. There are the really important issues, and there are the issues on which policy is actually likely to be made.

And that's an unfortunate distinction. The really long-term issues are issues of productivity growth, primarily, and all the various things that contribute to productivity growth, which include policies involving international competitiveness, and many areas that reach beyond the confines of economic policy proper.

Let me come back to those in a bit because I think the short-term situation is worth talking about a bit, and the policies that should and shouldn't be adopted right now.

The dominant feature right now is, of course, recession. And I don't have anything very illuminating to say about whether recovery has started, will start, or anything like that.

I think the important points to make about the recession are the following:

First, it doesn't really tell us very much about the problems of our economy. Some people would like you to believe that the recession is somehow the wages of our sins in the eighties. I don't think that that's true to any important extent. I think, essentially, the recession is a fumble by the Fed.

The Fed has consistently been behind the curve in loosening monetary policy to get us out of it; in the trade-off between inflationary and recessionary risks, they have consistently made the wrong bet.

But that just tells us that the Fed is human and makes mistakes. Not anything very fundamental.

In terms of recovery from the recession, I think we should probably realize that a strong case can be made that as much as half of the rise in unemployment that we've seen since the business cycle peaked is really not going to be reclaimed—not because the recession is doing long-term damage, but because we basically had an overheated economy.

All the evidence that we have from before suggested that 5.2 percent unemployment was too low, that our economy, as currently constituted, isn't really capable of running a sustained unemployment rate quite that low. The standard estimate that I believe of the nonaccelerating-inflation-rate-of-unemployment is in the range of 5.6 to 6 percent.

We don't really know that, but that's a good guess, which suggests that as much as half of the rise in unemployment is just getting back up to the point at which unemployment is at a long-term sustainable level.

So, the fact that we can't expect a dramatic recovery from this recession has nothing to do with the short-term forecasting issue. It's just that the economy probably can't really sustain a recovery to the levels of unemployment that we had before the slump began.

The thing that concerns me most about the recession, in a long-term sense, is what it may do to the whole issue of banking reform. And I think the banking system—the role of regulators through all of the credit crunch—has attracted a lot of attention and a lot of irresponsible pressures during this recession.

I think there's a big push to get the regulators to loosen up, and a lot of sense that, well, maybe we shouldn't do this banking reform because we need to keep credit flowing. The important point there is that there's a much better way for getting the economy started again, which is to just have the Fed lower interest rates another 150 basis points.

Meanwhile, I think that basic long-term economic logic is that the banking system is very, very seriously undercapitalized.

We can go into that at some more length, but I think the basic point is that the banking system has much less capital in reality than it appears to have on the books because it is so thinly capitalized that there's a really serious moral hazard— heads we win, tails the taxpayers lose—problems similar, although not as severe, to that which the thrifts faced during the eighties.

A reasonable estimate of how much capital banks really should have is not only far above current levels, but, indeed, far above the levels that are contemplated by any of the current regulations.

That can't be done all at once, but that's an important long-term goal. I hope the recession will end before we get into too much trouble and before we derail the whole process of trying to move back toward a sound banking system.

That's not a life or death issue for the economy, but it's an important long-term consequence of what's going on.

I should mention that this is a little more pointed because I picked up the *Boston Globe* this morning and discovered that my bank is being seized by the regulators.

REPRESENTATIVE HAMILTON. Which bank is that?

DR. KRUGMAN. Coolidge Bank and Trust.

REPRESENTATIVE HAMILTON. That brings it home, even to an economist.

DR. KRUGMAN. That's right.

The longer -term issues, the big issue is productivity. That's 95 percent of anybody's story about what really matters for the economy. And we have to give the honest answer about what to do to improve productivity, which is that nobody really knows what the secret is. There isn't any magic bullet—at least that we know about—that will, at relatively low cost, change us from very low rates of productivity growth up to Japanese rates of productivity growth.

My current belief, which is very hard to quantify, is that, if you really have to ask what is the single most important factor, it would come down to basic education, which is, unfortunately, not exactly a federal—it's difficult for federal policy to effect that.

But such evidence as we have suggests that the big productivity failings of American industry are not typically associated with outmoded plant and equipment, inadequate supplies of physical resources.

That doesn't mean that I don't think the United States should try to encourage more savings and higher rates of capital formation, but the characteristic failure of U.S. firms compared with the Japanese is at the shop-floor level.

It's the ability to organize production at a sort of micro level. And if you ask why is it that we do so much worse on that so consistently, I think the best answer that we can think of has to do with inferior quality of basic education.

That's not a proven hypothesis, but I think it's the story that makes the most sense.

Something which would make a contribution, I think, or could make a contribution is some more movement in the direction of what, I guess, we have to call industrial policy.

And I'm very hesitant to say very much about that because the big danger, when you talk about industrial policy, is that you get into a kind of Lafferism of the left.

Somebody says, yes, well, all you have to do is throw a little bit of money at a few key industries and, painlessly, without any need for dealing with things like getting our children to learn to read and write, we're going to really turn the economy around and have this explosion of growth.

I'm not proposing anything like that. I think the most you can say is that, intellectually, empirically, the case can be made that intelligent government intervention to promote certain kinds of industries in the economy is there.

The more I work, particularly on issues of regional economics, which I think are a revealing lens through which to view this problem, the more I'm convinced that that is the case.

If we did have such a policy, it would contribute, at best, a small fraction of 1 percent to our economic growth rate, to put perspective on these things.

But, at least, there is an area where something positive could be done short of a radical restructuring of things like our educational system.

Let me just repeat that and probably then just bring this part to a close. I think the immediate issues are: There is a recession. It's going to color and dominate economic policy for a while. But I don't think there's any fundamental lesson except that we need more expansionary monetary policy.

To me, there is a central short-term issue that could have long-term consequences, which is banking.

Long-term growth, the really important thing is education. But, perhaps, the implemental policy area—that is, something that could be done at a federal level—would be a limited policy of promotion of industries that have the right kinds of characteristics.

I think, maybe, if we want to pursue that, we could talk a bit more about what those characteristics are.

REPRESENTATIVE HAMILTON. Okay. Let's go. I'm not sure I heard your opening comment correctly, but you seemed to say that there are two different kinds of issues. There are the important issues, then there are the issues you can deal with.

And I gather by that that you mean we are not dealing with productivity—considered to be the big issue—the important issue—and we are dealing—we being policy people—with a lot of less important issues, by which you mean what?

DR. KRUGMAN. Banking reform would be an issue at that level. Industrial policy, if one could do it, would be an issue at that level. Monetary policy, budget policy. Very little of what goes on in actual policy, whether done well or badly, is likely to make an impact of more than——

REPRESENTATIVE HAMILTON. Are you suggesting that all of these big debates that we have around here about the budget—the budget deficit—are essentially unimportant?

DR. KRUGMAN. It depends on your definition of "important," Raymond Chandler once said:

> Other things being equal, the interest of a book depends on the importance of its subject. But there have been some very dull books written about God, and some very good ones written about how to make a living while staying fairly honest.

Policy very rarely deals with the really big issues. There are occasional junctures, I guess, when you can really have something that happens on the very big issues. But the normal scope of policy is a lot smaller.

REPRESENTATIVE HAMILTON. Why is that? Do policymakers focus on the wrong issue?

DR. KRUGMAN. I'm not sure.

REPRESENTATIVE HAMILTON. That's not an economic question, obviously.

DR. KRUGMAN. I'm not sure it's really the wrong issues. I mean, the answer lies basically in the public.

If you could convince the general public that doing something to really raise the U.S. productivity growth rate back up to something like historical standards was a crucial national goal, and people were prepared to accept substantial changes in the way that their lives were organized, such as sending their children to school about 25 percent more hours per year, then you could do something about it.

As long as the public is really not convinced of that, then it's very difficult for anything to start from Washington and change it.

REPRESENTATIVE HAMILTON. I want to get back to that, but let's just for a moment look at the recession on a short-term basis.

I think you suggested that the single-most-important thing that we could do is to lower interest rates fairly dramatically again.

DR. KRUGMAN. Yes. No question about that.

REPRESENTATIVE HAMILTON. The Fed, in your view, has been laggard here? Has been behind the curve; too little, too late?

Is that basically a description that you'd accept of the Fed?

DR. KRUGMAN. That's right. Yes.

REPRESENTATIVE HAMILTON. And, right now, what should they do?

DR. KRUGMAN. I would say that funds rates should be reduced another hundred or hundred and fifty basis points.

REPRESENTATIVE HAMILTON. And anything else with respect to the recession? How about the fiscal side?

DR. KRUGMAN. I'm opposed to that.

REPRESENTATIVE HAMILTON. Opposed to what?

DR. KRUGMAN. Opposed to trying to use fiscal policy to deal with recessions.

REPRESENTATIVE HAMILTON. Why?

DR. KRUGMAN. First of all, it's really unnecessary in the sense that monetary policy is an adequate tool for doing this. It's really a question of creating demand in the economy. Creating demand through monetary policy is like spelling Mississippi. It's easy to do; the problem is knowing when to stop.

The Fed has essentially all the tools that anyone needs to pull the economy out of the recession. Fiscal policy is a less clean tool. It involves that you either have to spend money on something or cut taxes for somebody to stimulate the economy. And that already involves muddying the waters, making a confusion between what really ought to be long-term policy issues and short-term issues.

REPRESENTATIVE HAMILTON. How much do you worry about the deficit, which is at $350-$360 billion, whatever the figure is? Does that worry you at all?

DR. KRUGMAN. No. I would like——

REPRESENTATIVE HAMILTON. If it were 600 billion, would it worry you?

DR. KRUGMAN. Yes. No, I don't believe that the deficits, in general, matter. This one, this high deficit that we're facing right now, the surge of the deficit is basically due to two things.

The recession, which depresses tax revenues, and we've known for a long time that you should basically discount recession-induced rises in the deficit. You should look at some high employment measure to assess the stance of fiscal policy. And there's a big surge in the numbers because of special expenditures, notably of thrifts. The important point about spending on the thrifts—well, two important points. First, it's transitory, we hope. But this is not going to be happening over and over. But much more important than that, it's not really an expenditure. It's actually simply the recognition of a liability that already existed. It's really just transferring some federal government liabilities from the hidden part of the balance sheet to the visible part of the balance sheet.

It's just giving people money that they already thought they had. And because of that, it isn't really an expenditure. It doesn't even raise demand in the economy. It doesn't crowd out domestic investment.

So, these very high numbers don't really worry me. The only thing that might worry you would be if you thought that the solvency of the Federal Government were in some sense at risk.

But we're essentially in no danger of that. Before these extraordinary temporary expenditures and the recession hit, federal debt was actually growing a little bit more slowly than gross national product. So, even——

REPRESENTATIVE HAMILTON. Is it advisable now for us to, as a matter of fiscal policy, to put the deficit on a downward track?

DR. KRUGMAN. Oh, yes.

REPRESENTATIVE HAMILTON. To some figure. And how would you define that figure? In other words, you agree that you ought to put the deficit in a downward slope. How rapidly and towards what goal?

DR. KRUGMAN. I would say zero. I mean, there's nothing magic about zero, but we are a low-saving nation. We are at the bottom of the league with a lot of air on top of us among industrial countries, in terms of our national savings rate.

Clearly, that's not a good thing for our long-term growth prospects. And I would take any means that we can to raise that savings rate.

REPRESENTATIVE HAMILTON. Incentives?

DR. KRUGMAN. I think it's worth trying tax incentives. But the thing that we know works is eliminating the federal budget deficit.

So, I would take it as rapidly as we can. But not out of a sense that there's a crisis. I think that we lose credibility if we say, if we don't correct this deficit, then the day of reckoning is just two years down the road.

There's no day of reckoning in the foreseeable future, it's just a good thing to have the deficit go away.

REPRESENTATIVE HAMILTON. You said something about unemployment at 5.5 or 6 percent is probably the lowest sustainable level?

DR. KRUGMAN. Yes.

REPRESENTATIVE HAMILTON. And what is it today? Six point seven or eight percent. So, we have a little slack. You could push the unemployment down more than it is.

DR. KRUGMAN. Right.

REPRESENTATIVE HAMILTON. Without seeing a resurgent inflation.

DR. KRUGMAN. I believe that we're clearly in the range where you can do that.

Maybe I should go back and say something about the Fed. I think, in a way, what's happened over the past year and a half is that the Fed, to some extent, has been getting exactly what the inflation hawks on the board wanted.

There was a lot of talk, to go back to early 1990, about having zero inflation in five years. And while there were some people who imagined you could somehow get that without a recession along the way, the staff at the Fed never believed that.

Basically, they said that you have to run the economy with some slack in order to get inflation down. And, in private, individuals at the Fed would say things like, "Well, we can't go out there and deliberately engineer a recession, but if a recession should come along, we should take advantage of it."

REPRESENTATIVE HAMILTON. Should we aim for zero inflation?

DR. KRUGMAN. No.

REPRESENTATIVE HAMILTON. Why not?

DR. KRUGMAN. The costs of getting there are just too high.

REPRESENTATIVE HAMILTON. Why does the Fed keep saying zero inflation is desirable?

DR. KRUGMAN. They have——

REPRESENTATIVE HAMILTON. Why does the Fed Chairman come up here and endorse a bill that is aimed at zero inflation, basically. It doesn't actually use that phrase. It is a level so low that it does not figure into economic decisionmaking—inflation.

Let's go back to the question: Why should we not aim for zero inflation? What is the problem?

DR. KRUGMAN. It is really just a tradeoff. I think the terms of the tradeoff are just much too harsh. Everything we have seen confirms for me, at least, the belief that if you give up something like four point-years of GNP to get the inflation rate down by 1 percent, then to get from an underlying rate of 4.5 percent down to zero, you would be giving up something like 18 point years of gross national product.

In other words, a trillion dollars. And the costs—the truth is that anyone who tries to estimate the cost of inflation at the kinds of rates that we have been experiencing comes up with positive but embarrassingly small numbers.

There's no evidence that these kinds of rates of inflation do any serious harm.

REPRESENTATIVE HAMILTON. An inflation rate of around 4 percent is not all that big a deal.

DR. KRUGMAN. It distorts some decisions. If you try to look at countries with 4 percent inflation and at countries with true price stability and ask whether inflation in that range seems to be associated with any deterioration and real measures of economic performance, you can't find it.

REPRESENTATIVE HAMILTON. Maybe we have learned something then as policymakers. I can remember the time when we put wage and price controls at 4 percent inflation, back in the Nixon Administration. Right?

DR. KRUGMAN. Yes. I remember the week that there was no toothpaste on the shelf. Sure.

REPRESENTATIVE HAMILTON. To jump back to another figure, 6 percent unemployment, we have redefined unemployment, too, haven't we? Or, what is the critical employment level? We used to think full employment was 3 or 4 percent.

We got worried when it began to slip up. And now you say, well, 6 percent is okay.

DR. KRUGMAN. I didn't say it was okay.

REPRESENTATIVE HAMILTON. Six percent still creates a lot of hardship.

DR. KRUGMAN. It doesn't have anything to do with what you like. That's always a problem you have. It is how high an unemployment rate do you need to keep inflation from accelerating. And if you chart unemployment against the inflation, it is a reasonable looking relationship, and it basically looks like it crosses zero at around 6 percent unemployment.

If you want lower unemployment, you have to change the structure of the economy. And there are things that you can imagine doing, most of them not very popular.

REPRESENTATIVE HAMILTON. And if you don't need to worry too much about inflation and if your unemployment rate is at 6 percent or lower— is it 6 percent lower?

DR. KRUGMAN. Or higher.

REPRESENTATIVE HAMILTON. Or higher.

DR. KRUGMAN. Inflation will probably not accelerate if the unemployment rate is above 6 percent. This is not a tight mechanical relationship. If you have an unemployment rate at the current level, you can expect that inflation will be slowly drifting downwards, on average.

REPRESENTATIVE HAMILTON. Right now, with respect to fiscal policy, we should stay with the budget deficit agreement, basically. Is that correct?

DR. KRUGMAN. Yes. I don't see any reason at all to change that.

REPRESENTATIVE HAMILTON. And the Fed ought to lower interest rates further?

Would you take any other steps immediately with respect to the recession?

DR. KRUGMAN. No.

REPRESENTATIVE HAMILTON. The major thing is to lower the rate. And on the longer term side of things, I want to go into your thoughts with regard to productivity. And I would like you to be a little more specific about that.

Surely, you fellows must know a little bit more about getting productivity going than to just say that there isn't any magic bullet.

You talk about education, but you know education is the solution to every problem in the country.

What do you mean by "education?" Isn't more money into commercialization of research and more money into infrastructure important in getting productivity up?

What do you say about productivity?

DR. KRUGMAN. Let me tell the story, as I understand it. The first question is: What do we think we know quantitatively?

I guess Bob Solow spoke to this.

Congressman Hamilton, did we have a bell?

[Discussion off the record.]

REPRESENTATIVE HAMILTON. Go ahead.

DR. KRUGMAN. There is a procedure known as growth accounting, which Solow may or may not mention next time, which amounts to saying: If you value things like capital and education and labor at their market returns, how much of the growth in productivity can you account for by the increase in these measurable inputs into production?

So, if the average educational level rises by one year of schooling, you can look at how much more do people who have an additional year of school actually earn?

And that means that we ought to see that productivity should rise by that amount. If capital earns at an average rate of return of 11 percent, if you add another dollar's worth of capital, it ought to raise gross national product by 11 cents.

When you do that kind of growth accounting exercise, what you invariably find is that a large part of the growth in productivity is not accounted for. And, furthermore, that a large part of the differences in productivity growth between countries is not accounted for. And this is known technically as a residual, which is a fancy way of saying that it is the stuff that is not accounted for.

In the big discussion, any effort to account for anything like the productivity slowdown in the United States after 1973, or our failing to grow as rapidly as Japan, ends up focusing on the residual and the residual is—because we can't capture it by this—inevitably is a much fuzzier thing to talk about than these measurable inputs.

I will steal his thunder. Solow says: "All efforts to produce productivity growth end up in a blaze of amateur sociology."

We have some things that we think do contribute to the residual. One is infrastructure. There is no real way of measuring that. It seems obvious that the fact that U.S. infrastructure used to be the best in the world and is now very far from being the best must have some impact. And that is certainly something that you can do at a federal level.

We have reason to believe that education matters more than the growth accounting suggests. And the reason is, the return to having everybody have one more year of education is probably a lot bigger than the return to any one person having one more year of education.

It is a kind of network effect, working with people whom you can count on to be literate and numerate is worth a lot over and above myself being literate and numerate.

Similarly, R&D yields benefits that go beyond the market value to the firm because other firms get to learn from one firm's R&D.

This is a grab bag. It is a stew. When I say we don't know, I don't mean that we don't have thoughts about what is in there, but we don't know the relative importance of all of these things.

What you can say is the United States is doing poorly on all of these things that we suspect contribute.

REPRESENTATIVE HAMILTON. Is long-term productivity growth—how does the line go long-term, say, if you look back over 30 years or so, going up more slowly?

DR. KRUGMAN. Yes. We basically achieved productivity growth rates of close to 3 percent during the period between the end of World War II and the early seventies. And it has been 1 percent, plus or minus a little, since then.

Those numbers——

REPRESENTATIVE HAMILTON. We have not been able to isolate where that change occurred?

DR. KRUGMAN. No, you can't. On January 15, 1973, productivity growth slowed down. But somewhere around there, the trend broke.

I would actually say that there are no plausible economic explanations of what happened.

REPRESENTATIVE HAMILTON. Let me try to ask you about the relative importance of the various things that you have talked about, with respect to productivity growth, or others have talked about.

We talked about new plant and equipment. You talked about infrastructure. You talk about research and development, education and training. You obviously put more weight on education than the other factors.

DR. KRUGMAN. That strikes me as being so pervasive, so universal. And there is such a contrast between ... the United States is still the richest major country. We still have probably the highest productivity even now, although the growth is much less than other countries.

And we also have, by all measures, the worst basic education in the industrial world. Basic. What children know on coming out of high school is so much worse in this country, on any kind of comparative test, than what they do in other countries.

That contrast has to mean a major explanation of why the productivity growth is low.

The others—R&D—we do a little bit less. Civilian R&D is a smaller share of GNP now, compared to Germany and Japan. But you wouldn't call us a low R&D country, yet. That is unlikely to be a major explanation of why we are doing badly.

Infrastructure, we certainly are underinvesting in public capital compared with other countries, compared with our own past history. We try to think about where it really applies.

You say we have a lot of traffic jams, a lot of air traffic delays. The phone system is no longer superior to other countries.

Those things probably matter. But if you just try to tell the story, it is hard to think that those are really the key to what is going wrong.

REPRESENTATIVE HAMILTON. Excuse me.

[Discussion off the record.]

REPRESENTATIVE HAMILTON. And R&D. You were commenting, I guess, on R&D.

DR. KRUGMAN. There is still a lot of R&D being done in this country. It is not noticeable that we are radically underinvesting in R&D.

REPRESENTATIVE HAMILTON. We're putting more into military versus civilian R&D?

DR. KRUGMAN. We are the highest R&D country in the industrial world. If we count the military, then we're somewhat lower on the scale. I'm not sure they are competitive.

The military probably doesn't contribute very many spillovers to the civilian sector at this point. I don't really buy the argument that says we are pulling resources out of civilian R&D into military.

I think the supply of engineers and scientists for these things is really quite elastic. I don't think that that is the problem.

REPRESENTATIVE HAMILTON. You did not exactly make a ringing endorsement of an industrial policy. But you seem to be moving in that direction.

And you said that, I think, there were some industries that had the right characteristics, that put some government money into it.

Do you want to explain that a little bit more?

DR. KRUGMAN. Sure. This requires that I talk for a minute about the general idea. Maybe, I can start with the example.

If you look at regional specialization, I think that that is useful to do as a way of getting away from the kind of abstractness that happens when you talk about international competition.

You ask why do particular locations, cities or regions have industrial specialties? Why do certain things work?

What you end up with is that it is very rarely in the modern world the specific resources of the area. There are not many places in the United States now—not many major centers—that owe their living, their livelihood, to some particular mineral that is mined there, or anything like that.

What you typically have in many, many cases is an industry that, having started in some area for some reason, or having developed an advantage there, develops a self-reinforcing advantage.

A good example that one might not think of is to take some place like Rochester, New York. Rochester has Kodak. It has Xerox and Bausch and Lomb. Rochester's business is actually optics. And why are all the firms there? They are in Rochester, along with a lot of people who know things about optics. A lot of knowledge is floating around in the community about how to do things related to optics and a lot of specialized suppliers who can do things with lenses and light, and so on.

But why are those people there?

They are there because of Bausch and Lomb and Kodak, so it is a self-reinforcing process. And it generates a viable industry. The same is true of Silicon Valley and Route 128. Almost all of the carpets in the United States are produced in the small area of Northwest Georgia, around the City of Dalton. And it is the same thing—specialized supplier-skilled labor force—specialized knowledge.

What that tells you is, competitive advantage—productivity in industries—is not simply a source of success, but is caused by success. And it is caused by self-reinforcing process. It is caused by a process that is greater ... I guess you can call it a sort of social construction productivity.

It is not simply the result of the efforts of individual firms. These industries, these local specialties are more than the sum of their parts. Firms contribute something that goes beyond their own rewards, in terms of success, because they help create the environment in which other firms can succeed.

Once you recognize that that is pervasive in competition between localities in the United States, then you say that that matters in international competition as well. And, indeed, it is true. Whether we're talking about something like Swiss watches, something like what was once the U.S. dominance of semiconductors, you often find that success in international competition is the product of these kinds of self-reinforcing advantages.

As a matter of principle, clearly, if you can start the circle rolling, if you can provide seed money in the form of support for R&D—joint government/business research institutions; in effect, government venture capital—you can help to promote productivity in these particular industries.

Representative Hamilton. You said intelligent government intervention. That makes me think that you have some doubts about government's ability to intelligently intervene.

Dr. Krugman. It is unfortunately and depressingly easy to imagine how one could pass an act with the best of intentions to do this, and then find out that, in the actual process, someone decides that the production of widgits in upper Slobovia is just what you have to do because a powerful congressman happens to have a seat there, or the brother of the Commerce Secretary happens to own some land there.

The great danger of any sort of policy like this is that it would have to be based upon sophisticated criteria. And as soon as the criteria are sophisticated, it means they are arguable. And as soon as they are arguable, you have opened up the way to possibly dangerous pork-barrel politics.

And this is why one worries about it.

Representative Hamilton. We have a lot of experience with industrial policy. We have DARPA, for example.

As you look at the government today and where you see government intervention in various areas, how do you think it is working?

Dr. Krugman. Let's take the long view. We have a mixed record. A good example of this kind of policy is the Agricultural Extension Service, which is not in its prime right now, but has historically been dramatically successful at promoting technological development.

You can argue that, in the early post-War period, the Defense Department, in effect, carried out industrial policy in promoting such things as the growth of our aircraft industry.

I think that has to be recognized as a successful policy.

You can then easily come up with horror stories—synfuels. It is a mixed record. My belief on this is that we have gotten into a self-defeating cycle on any sort of government policy that involves more than the most basic functions. We are extremely cynical about these policies.

We say that government never does them right. We underpay, relative to the private sector, the people who are supposed to administer these things, so the people you get are either not very good or are intending to go out the revolving door in two years.

The policies that work out badly or are captured by special interests, and we say, "see," and continue to do the same things.

Among the political problems, there is the pork-barrel problem. But on the other hand, given the cynicism that we have in the government now, one of the problems that you would have here is that there will be some failures. There will be some mistakes. There will be some lemons.

And, of course, the private sector has lemons, too. It wasn't the Congress that decided that Donald Trump was a genius at real estate development. But when the private sector makes mistakes, you say, "Those things happen." When the government makes mistakes, it feeds our cynicism.

REPRESENTATIVE HAMILTON. So, you come down, then, on the side that we ought to try government policy, government intervention, in selected industries. Right?

DR. KRUGMAN. Yes. I mean, the simplest thing, the least open to abuse, would be to say that two or three mini-sematechs—government/business research consortia—are probably not the whole of what one ought to be doing, but they are relatively clean policies.

REPRESENTATIVE HAMILTON. Suppose somebody gave you several hundred million dollars to pass out now to put into industries?

DR. KRUGMAN. Several hundred million?

REPRESENTATIVE HAMILTON. Yes. Where do you think we ought to put the bucks in order to improve our economy?

DR. KRUGMAN. Let me be honest and say that I don't immediately know. I think part of the point is that we need to actually do some serious work. But I would probably at that point put it into a relatively unglamorous, but possibly, key technology; things like numerical controlled machine tools.

I think, some areas of semiconductors, possibly software development. This is off the top of the head.

REPRESENTATIVE HAMILTON. I understand. You mentioned criteria that would become very important. Do you have some specific criteria in mind as to which industry you would put money into?

DR. KRUGMAN. The broad criteria, and these are not yet the operational criteria—the broad criteria—it has to be an industry where it seems likely that this kind of self-reinforcing process is important.

So, it has to be an industry in which, in effect, the industry is a network of a number of firms and a labor market that is shared, and information flows between firms.

It also has to be an industry with those characteristics that seem appropriate for the United States, in terms of our underlying comparative advantage.

Maybe I can best define that by giving you two examples of industries that I think are probably not suitable.

At this point, one would be the large commercial aircraft industry. The reason is that that's not an industry where there is a network of firms, and the whole is greater than the sum of the parts because it is essentially one firm industry at this point.

In the jargon of the economist, Boeing internalizes the externalities. We don't need this kind of government policy to make them happy.

REPRESENTATIVE HAMILTON. What does that mean, internal the external?

DR. KRUGMAN. It means, in an industry——

REPRESENTATIVE HAMILTON. We have several economists here. They don't know what you're talking about.

[Laughter.]

DR. KRUGMAN. In an industry in which there are a number of firms, workers move between those firms, skills are passed back and forth, and ideas about how you do things are swapped between firms over a beer in the evening.

When one firm makes an investment in R&D, the returns to the Nation are considerably larger than the returns to the firm, because the returns actually spill over to the other guys, if this happens.

You have 80,000 people working for Boeing. Then, the guy you have a beer with and talk about how you do things is all inside Boeing. It is a one-company issue.

REPRESENTATIVE HAMILTON. How much do you worry about the U.S. competitive position in the world?

That is a major concern among my constituents. And if you ask them whether the American economy or the Japanese economy is doing better, they almost all of them tell you the Japanese economy is doing better.

And, of course, as you know, there is an enormous concern about the loss of jobs.

How serious a problem for us is our competitive position?

DR. KRUGMAN. Competitiveness is a bad word. It makes it sound as if a country is like a company. If you don't make as good a product as the other guy, you can't keep your costs down, you go out of business.

That doesn't happen with countries. If worse comes to worse, they devalue their currency and find a way to export. So, there really isn't a competitiveness problem. That is separate from the productivity problem.

Basically, the standard of living that we get depends on our productivity. That is true whether or not you're in a trading world, and the United States is not doing worse than you would expect, given our low productivity growth.

We are, in fact, doing a little bit better because we have the ability to trade with all of these other countries that make goods that we would have a hard time making for ourselves.

Our competitive position is only to the extent that we are lagging behind in productivity and also, perhaps, tending to lag behind in some of the industries where productivity will be generated in the future.

REPRESENTATIVE HAMILTON. What would a Japanese productivity increase be year-after-year?

DR. KRUGMAN. They're doing at least 4 percent a year.

REPRESENTATIVE HAMILTON. Is Germany comparable?

DR. KRUGMAN. Less. Two and a half.

REPRESENTATIVE HAMILTON. Japan is 4 percent. The Germans are doing 2.5 percent, and we're doing 1 percent?

DR. KRUGMAN. Yes.

REPRESENTATIVE HAMILTON. That has been going on for some time.

DR. KRUGMAN. That disparity in productivity growth rates has been there since 1950. It used to be that we could say that they were far behind us. And it's natural that they were growing rapidly because they're catching up. That argument doesn't wash any more.

Let me just say, the one thing that competitiveness is definitely not about is jobs. We are actually the champion job creators in the industrial world. We have managed to employ a much larger increase in our labor force over the past 20 years than anybody else.

We are not to any significant degree de-industrialized by trade. If you want to find an issue to worry about, it is not the overall loss of competitiveness. It is the kind of goods in which we seem to be finding our competitiveness now that are moving down the scale.

Since the dollar began falling in the mid-1980s, we have recovered a lot of ground in export markets and, even to some extent, in domestic markets.

But we have continued to lose ground in the high-technology industries, while most of the ground we have regained has been in the sort of plain vanilla industries, like pulp and paper, bulk chemicals, and so on.

REPRESENTATIVE HAMILTON. And wages are lower in those industries?

DR. KRUGMAN. No. Sometimes, they are. Sometimes, they aren't. The crucial question is not the wages really, but the self-reinforcing process of technology generation.

Let me say again, part of the reason that it is so hard to do an industrial policy is that the right criteria in terms of basic logic are not the ones that appeal most naturally, that we want the high-value industries. We want high value added for work curve.

REPRESENTATIVE HAMILTON. What do you say to the person who says to you, "Congressman, we need more high-paying jobs in this country?"

How do you answer that question?

DR. KRUGMAN. The first thing you say is most high-paying jobs are there because they are held by high-skilled people. Most of the systematic differences are things that you can account for.

If you say, let's try to promote those industries that have high-paying jobs, what you will end up doing is raising the demand for high-skilled labor, reducing it for low-skilled labor and worsening the income distribution that has already been moving outrageously in a skewed direction.

There is some evidence which I think is right, but I don't like to lean on too heavily. Some industries pay systematically high wages even for equivalent jobs. You could probably push those and raise the national income a bit.

But that sounds to me like too narrow, too uncertain a basis on which to ... the best thing is to make all of our jobs higher paying. And the way you do that is by raising the productivity across the board.

REPRESENTATIVE HAMILTON. Do you support a free-trade agreement with Mexico?

DR. KRUGMAN. Oh, yes.

REPRESENTATIVE HAMILTON. Yes?

DR. KRUGMAN. Yes. Certainly.

REPRESENTATIVE HAMILTON. Why?

DR. KRUGMAN. Three reasons. First, I think it makes very good economic sense. This is a case where gains in trade are almost certainly substantial. On the general grounds, increasing size of the market, we can specialize in producing different things.

And for that matter, the kinds of industries where the Mexicans are likely to displace some U.S. production are our low-end industries that are not going to generate a lot of technology development. And the ones that will expand are exactly the ones that you would like to expand.

The second reason is—this is speaking in civilian clothes now—it seems to me that there is an overwhelming political case for this. This is the best Mexican government that we could possibly imagine having if we really need it.

I think it would be inconceivable to deny them what they want.

And the third reason is the Finance Minister is my class mate in Mexico. And all of his staff is MIT trained. And these are our students.

REPRESENTATIVE HAMILTON. You mentioned a moment ago something about outrageous income distribution. Do you want to elaborate on that a little bit for us?

How does the fairness issue strike you in the economy? How important an issue is it in terms of the economy?

DR. KRUGMAN. Over the past dozen years or so, since we have had very slow productivity growth, actually, the dominant factor in determining how different parts of the U.S. income distribution have fared is, in fact, how that income is distributed.

We have had about a 10 percent rise in the overall output per person, but very large movements in the way that pie is distributed. So, one sees at the bottom of the income distribution the shortfall in real incomes.

At the middle of the income distribution, essentially, no gain or slight decline. And, at the top of the income distribution, a very large rise.

So, it is clear, for the first time—certainly, for the first time since 1950—the movements in the distribution of income, as opposed to the overall level, have made a big impact on the standard of living of people in this country.

REPRESENTATIVE HAMILTON. Apart from the political implications of that and human implications of it, looking at it from a strictly economic point of view, does it make any difference how income is distributed across the population?

DR. KRUGMAN. The best you can say, in general, is that there is no clear-cut impact on productivity growth. I would say that we have a prospective problem probably already existing. One thing that is certainly going to be a drag on our productivity growth in the future, and it is starting to be a drag already, coming back to education, but maybe broader than that, is the whole question of the underclass children raised in poverty.

As it now stands, I guess 20 years from now, something like one-fifth or a quarter of the people entering the labor force will be children who have spent a substantial fraction of their childhood in poverty.

That has to have a negative impact. The problems of poverty, the problems of the underclass are not solely a product of this income distribution. But that decline in real income at the bottom is not helping on those problems.

REPRESENTATIVE HAMILTON. In bringing them up, would that help our productivity?

DR. KRUGMAN. We would point out that a lot of what is pushing more people into poverty, a lot of what is pushing down the bottom of the income distribution is not just the underclass problem—the people who never work. It is a sharp decline in the wages earned by unskilled labor.

REPRESENTATIVE HAMILTON. I'll tell you, I'm running out of time because of other commitments, and I know your time is short, too.

I have covered most of the questions that I am interested in, with maybe one exception, and that is a general question on the quality of economic statistics.

Do you have any just general observations about that? You have been dealing with these. I'm speaking now about federal statistics.

What is your comment about it? Are they worse? the same?

DR. KRUGMAN. They are worse. On some specific policy issues on which I've worked, it is astonishing to me that we can have so much national debate and so little effort, be so understaffed, so underresourced in the collection of basic statistics.

I have been working on the issue of foreign direct investment in the United States quite a lot over the last few years.

Simply because of staffing, there is a very small group of people at the Bureau of Economic Analysis who put together what is really the key information on what we know about foreign-owned firms operating in this country. They are good people. This is not a problem of bureaucracy. They lag several years behind. We have, for the most part, information for only years 1987 and 1988 on what foreign firms do in this country. In other words, well before many of the foreign acquisitions that we would like to be assessing.

I think that is just another example in the international area. I think that is just a sample.

Another example is in the international area. We were dramatically concerned about the apparent failure of the dollar to force foreign firms to raise their prices in the United States, which was very evident in the statistics.

The only problem is it wasn't true. It has turned out that some people outside of the government—Robert Lawrence at Brookings, and others—have taken the statistics apart, excluded the questionable things like computers where the pricing indices are problematic, and discover that, when you look at the things that you can measure accurately, it is not happening.

So, there is a very basic international statistic. And it is wrong. And I think the problem is lack of resources to do it right.

REPRESENTATIVE HAMILTON. One other thing.

You spent a lot of time looking at the trade question. What is the right policy response from the United States to the huge trade deficit?

DR. KRUGMAN. Let me split that. I don't think that our trade policy, with respect to Japan, should really be influenced by the trade deficit. The issue of our trade deficit with Japan is neither the bilateral deficit nor our aggregate position. Those are questions that are issues of exchange rate policy, monetary policy.

And I don't think they should really be the focus of our trade policy. Our trade policy with Japan, if the Japanese went ahead and we somehow found a way to let them buy Alaskan oil, and the Japanese started buying $20 billion a year of Alaskan oil so that the trade deficit with Japan fell by $20 billion, I don't think that would change anything about what was appropriate for our policy with regard to Japan.

I think we need to be fairly aggressive with Japan to carve out markets. I think lots of shots across the bows are appropriate.

Again, on these things, you always have to keep perspective. I don't think the competition with Japan is the big problem of U.S. economy. I think our problems of living standards and productivity are 95 percent homegrown.

Japan is not the sort of space ship——

REPRESENTATIVE HAMILTON. What shots across the bow?

DR. KRUGMAN. We should be threatening retaliatory action where their markets are closed.

REPRESENTATIVE HAMILTON. You feel their markets are closed to a large extent to us?

DR. KRUGMAN. Yes. The problem with it is that Japan is, in many cases, they are *de jure* open and *de facto* closed. And that means that we also have to have results-oriented policy. It is not enough to simply require that explicit import quotas be removed, but we must also say, "Look, we want to see something happen there."

I'm reluctant to advocate this. I advocate free trade and, for the most part, I want to. I do.

But getting tough with Japan actually does work, mostly. It doesn't produce dramatic results, but it does produce results.

REPRESENTATIVE HAMILTON. Getting tough means you have to look at the trade deficit though, doesn't it?

DR. KRUGMAN. No. It means looking at particular products. I would say, saying that we have a billion-dollar-trade-deficit with Japan is a bad statistic to use. Saying U.S. producers of microprocessors have 80 percent of the world market outside of Japan and only 20 percent in Japan is a very good statistic to use. That is clear evidence that something funny is going on.

REPRESENTATIVE HAMILTON. Well, thank you very much, Dr. Krugman, for your comments this morning. We appreciate greatly your coming up to visit with us, and we will stand adjourned.

DR. KRUGMAN. Thank you.

[Whereupon, at 10:40 a.m., the Committee adjourned, subject to the call of the Chair.]

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

THURSDAY, OCTOBER 17, 1991

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

The Committee met, pursuant to notice, at 10:25 a.m., in room B–352, Rayburn House Office Building, Honorable Lee H. Hamilton (vice chairman of the Committee) presiding.

Present: Senators Sarbanes and Bingaman, and Representative Hamilton.

Also present: Chad Stone, David Podoff and Dorothy Robyn, professional staff members.

OPENING STATEMENT OF REPRESENTATIVE HAMILTON, VICE CHAIRMAN

REPRESENTATIVE HAMILTON. The meeting of the Joint Economic Committee will come to order.

Today's is another in a series of roundtable conversations that the Joint Economic Committee is holding with prominent economists to discuss the state of the economy and economic policy.

We are pleased to have as our guest today Robert Solow, Institute Professor, Department of Economics, Massachusetts Institute of Technology.

Professor Solow was awarded the Nobel Prize in Economics in 1987 for research that focused economists' attention on some of the most important questions about economic growth. He served recently as Vice Chairman of the MIT Commission on Industrial Productivity, and was a principal co-author of the Commission's book, *Made in America: Regaining the Productive Edge.*

Alan Blinder, who appeared at one of the roundtable conversations about a month ago, found Keynes' description of the "Master Economist" applying to our guest: "One who must understand symbols and speak in words; one who is as aloof and incorruptible as an artist, yet, sometimes as near to earth as a politician."

So, we are pleased to welcome you, Dr. Solow, and we look forward to our discussion.

I think you have probably been informed that the conversations are of the one-over-lightly approach to economic policy, just to get your general views of what you think we ought to be doing.

So, I would like to ask you to begin with a few comments on how you see the economy at the moment, and how you see economic policy, and then we will pursue in greater detail through questions, after you have had a chance to make your opening comments.

STATEMENT OF ROBERT M. SOLOW, PROFESSOR OF ECONOMICS, DEPARTMENT OF ECONOMICS MASSACHUSETTS INSTITUTE OF TECHNOLOGY

DR. SOLOW. Thank you, Congressman Hamilton.

I am grateful to you for inviting me. I am especially grateful that this is one occasion when I did not have to pretend to know what was going to happen to interest rates in the next 6 to 9 months.

[Laughter.]

DR. SOLOW. And I would, in our conversation and what I say now, try to emphasize medium-run problems rather than the current business cycle, because I think this is a rare opportunity to do that.

So, the points I want to raise and mention in particular really have a 5-year time horizon.

REPRESENTATIVE HAMILTON. You know Senator Sarbanes who is joining us here.

DR. SOLOW. I do know SENATOR SARBANES. Hi, Paul.

SENATOR SARBANES. How are you?

REPRESENTATIVE HAMILTON. We are just getting started.

DR. SOLOW. I start from the fact that everybody in the country, just about, is conscious of a loss of relative dynamism and competitiveness in the American economy, symbolized not by anything that happens from month-to-month or quarter-to-quarter, but the stagnation of real family income over a period of a couple of decades.

I want to make just three substantive points.

I have made a very good career out of sticking to the notion that the three major contributors to a nation's capacity to produce are capital, labor, and technology.

It is one of those simple thoughts which, pursued over 35 years, has me sitting opposite you, and I want to propose one thought about each of them—about capital, labor, and technology.

Let me take capital first.

The United States is a high-consumption economy. I went to the library and put together a few figures for you just to fix the orders of magnitude.

Over the last 4 or 5 years, the United States has consumed, that is, devoted to personal consumption, 65 percent of its GNP; Japan and

Germany have consumed 57 to 58 percent of their GNP; France, 60 percent of its GNP. The only other major industrial country that consumes as much as 65 percent of its GNP is Great Britain, which is not exactly an example that one would want to follow.

So, we consume between 5 and 8 percent more of our national production every year than our main industrial rivals: Japan, France, and Germany. And the same difference, just the other way around, appears if you look at plant and equipment spending.

We spend 5 to 7 percent of GNP, less per year on investment than our main rivals. We should, I think, be trying over a decade to shift about 5 percent of our GNP away from consumption and into investment.

I say "investment" rather than "savings." We often talk about the need to stimulate saving. But there is enough slack in our economy, so if we could generate a little more dynamism on the investment side, the saving would appear.

Our investment ratio has held up over the last few years. That is not the point. The point is that it has held up at an unsatisfactorily low level. It is not easy to shift 5 percent of GNP from consumption to productive investment.

One of the reasons it is not easy to do that is that real interest rates, the cost of capital to a business firm thinking about investing, are very high in the United States. They are very high everywhere around the world, and they are unlikely to fall soon for reasons we could discuss later if you wanted to. We cannot hope to maintain a differential. There is no way in the modern world that the United States can have perceptibly lower real interest rates than other industrial countries because our savings would simply drift abroad, and other peoples' savings would not come here.

I think we have to look for a fiscal stimulus targeted on investment, something like a better investment tax credit. At the time of the Revenue Act of 1986, the investment tax credit fell into disrepute because it unfairly and unintelligently discriminated among different kinds of capital equipment. I would have thought that the right thing to do would be to make it better, but instead the Act simply dropped it. I would like to think about an even more focused investment tax credit, perhaps a credit on net investment rather than gross investment. That would favor young firms in particular, but it would be good for several reasons.

There is a distributional problem that always arises when a country thinks about stimulating investment. The way to get more investment in a market economy is to make investment more profitable. Making investment more profitable often has the side effect of transferring income from workers to investors, from poor people to rich people. That side effect ought to be minimized.

Any economist on your staff could produce an investment tax credit that would be very focused on the margin and have a big effect on any firm that was just on the verge of investing a little more, and could arrange to recapture the revenues elsewhere within the corporate system.

Those schemes get a little Rube Goldbergy, but after you look at them for awhile, they look sensible.

Anyhow, the moral of the capital side of this is, I think, that the Congress ought to be looking for focused ways to shift 5 percent of the demand for goods and services in the United States from consumption to investment. I think that is an effort that will take a decade.

I want next to say something about labor as a resource for production.

It seems to me that the main American deficiency on the labor side comes in the transition from school to work. Vocational educational has been a long-term scandal in the United States

When I worked for the Council of Economic Advisers in 1961 and 1962, one of the first assignments that Walter Heller gave me was to look at vocational education. I did not like what I saw, and it has not gotten any better.

The example to copy in this case is Germany, which has an excellent system that carries young people from school into the work place. The key to a good vocational education system is to get industry involved. Local industry is needed to specify the training that they want in workers; also, to create some kind of an apprenticeship program so that young people in their last years of schooling can combine education and work. Then, third, industry has to crash through with jobs, or else there is no real motivation for students to go through this. German industry, which is fundamentally no different from American industry, is able to do all of these things.

When I looked at vocational education in 1961 and 1962, one of the things I found was that businesses donated obsolete machinery to their local vocational schools in exchange for a tax deduction, and then complained bitterly that the schools graduated people who were trained to work on obsolete machinery. I think that a combined effort among local business communities and vocational education institutions could do the trick. I would even have hopes that literacy and arithmetic and all those earlier requirements would improve by themselves when there is a clear purpose.

Now, I know that vocational education is not the Federal Government's business, but I think that the Federal Government might target some funds on a few well-financed demonstration programs for three or four industrial cities.

It is absolutely necessary in doing this to get local industry involved—not just large firms, or the largest city—but self-help and cooperation in business communities in producing the kind of labor they are going to need would be a very good device to try to bring about.

The last thing I want to say is to make some comments on the technology side of things.

It is obvious that the United States has to focus on its R&D establishment, and lots of schemes have been proposed. One possible approach is to get the extraordinarily excellent military R&D establishment moved, ever so slightly, at least, to civilian purposes.

The example that one often thinks of in this connection is DARPA—the Defense Advanced Research Projects Agency. DARPA has been extraordinarily successful at eliciting high-tech military research and development and hardware from its own clientele.

Now, I think DARPA has had a big advantage in that the Defense Department is also the ultimate buyer of the things that get produced; and that suggests to me that an agency like DARPA, or perhaps DARPA itself, might start in the civilian area in places where government would be a main buyer, such as with intelligent highway systems or air traffic control.

I do not want to elide the fact that there is a major cultural shift in going from doing defense work with one client, where you produce tens of items worth millions of dollars each, to going to a business where you have to compete with firms all over the world for the attention of consumers, and produce millions of items costing tens of dollars each.

But if there were a way of directing federal policy toward promoting the sort of high-class technological expertise that now goes into defense into civilian industry without the government trying to micromanage the business, I think a lot of good could come from that.

There, too, I think that one has to keep away from focusing entirely on the largest firms. Small- to medium-sized firms are very important here. The Agricultural Extension Service is a good model for us to think about.

Those are all the remarks I wanted to make, and I would be happy to talk about anything else that you would like.

REPRESENTATIVE HAMILTON. Well, good. That gets us started off.

Paul, do you want to go ahead, since your time is fairly limited?

SENATOR SARBANES. I appreciate that, Lee, very much, because unfortunately I am going to have to leave.

As I indicated, I think these sessions are a terrific idea.

Bob, let me ask first of all, when you talk about investment under "capital," do you include public investment there?

DR. SOLOW. Yes, I certainly do.

There is, as you know, an argument going on as to how much public capital in the form of infrastructure contributes to private productivity. I think that research question has not yet been satisfactorily answered. But the answer, whenever it comes out, will certainly be that it contributes a measurable amount. So, I would include, as I mentioned, things like the air traffic control system, the transportation infrastructure, under the general heading of the sort of capital formation we need to be encouraging.

SENATOR SARBANES. What about consumption taxes and enhanced investment spending? I mean: gasoline taxes, liquor, tobacco taxes, etc., all of which are significantly lower than in the other countries that you were pointing out, leaving Britain aside. In all of those countries, my perception is that their public investment is at significantly higher levels than in the United States.

DR. SOLOW. I would certainly confirm that last observation.

The public investment on the Continent of Europe, not so much in Great Britain, although there are heavy fuel taxes in the United Kingdom, as well, but the public infrastructure is much better. And I have no doubt that it pays.

I could not agree more about the desirability, when new taxes have to be found, of choosing taxes that have their principal effect on consumption. I think taxation of energy use is an obviously good thing to look at for several reasons.

My old friend and your old friend, Joe Pechman, when I would say these things to him, would always balk and reply: "The income tax is the fairest tax we have, and let's stick with it rather than trying to become more versatile." I tended always to defer to Joe Pechman, who knew infinitely more about the tax system than I do, but my instinct still tells me that shifting to consumption taxes is a very good idea.

One of the advantages of a consumption tax is that—this is what Joe Pechman would never believe—you could in principle make it at least as progressive as the personal income tax is; whereas, ordinary excise taxes are, at best, proportional.

SENATOR SARBANES. Of course, you could do the consumption taxes and make the income tax progressive simply at the upper levels, not so much to produce large revenues, but to put an equity element into the tax system.

DR. SOLOW. To make it fairer, yes. I would have no objection at all.

SENATOR SARBANES. Now, on the R&D in the DARPA-like agency, how do you address the question that you are putting the government into the business of picking winners and losers, and that it is the strength of our system in that we do not do that?

DR. SOLOW. I would not try to say this branch of the textile industry or some other branch is a winner, and therefore we will try to elicit R&D for them. I thought the place to start is in the public sector, in things like transportation and energy, where there already is a public presence, and where the government is in fact a buyer of new products. Even if one succeeds in that and the idea is carried toward ordinary private goods, I think it can be done without trying to pick winners and losers. I will try to explain how.

There is good microeconomic justification for the notion that a private enterprise system, as well as it does some things, will underinvest in research for well-understood reasons. It is then perfectly okay in any textbook, no matter how classical, for public funds to be used to elicit R&D spending. Let the private sector compete for the use of those funds by putting up some of its own money. Then, those industries that see their own futures as the most promising will bid and will offer to match or overmatch public funds.

In that way, the government is not really in the business of choosing between one industry and another on the basis of its own evaluation of that industry's future. I do not have any confidence in the government's ability to do that.

By the way, I do not have any tremendous confidence in industry's ability to do that, either. But it is the essence of the system that they are to put up their own money and take their own chances.

SENATOR SARBANES. Do you have any figures that would measure whether this gap in our investment is in public investment, or in private investment, as compared to these other countries?

DR. SOLOW. No. I do not have those figures here.

I am not sure whether I could get them. The source I was using to put those figures together did not produce a separate public investment figure. If you are interested, I could go back home and try to dig up the figures on that and send them to you, which I would be happy to do.

SENATOR SARBANES. Well, if you could, because it seems to me that we tend to talk about investment in this country as though it is only private investment.

DR. SOLOW. I agree.

SENATOR SARBANES. These other countries obviously have an emphasis on public investment. In fact, the Europeans are going to make an investment in rail transport, which is just incredible in terms of the commitment and the network they will then establish.

DR. SOLOW. Yes.

SENATOR SARBANES. It is a little bit like the Reagan years. I mean, there was government spending, not only domestic spending.

Somehow, military spending did not constitute government spending. There was a complete disconnect in the concept. It was disaggregated and only a part of it was focused.

DR. SOLOW. Yes. I will try to dig up some figures that will allow us to combine private and public investment by country. The numbers I gave you were strictly private investment. Not every country in its national accounts separates out a visible public investment, as distinct from other public expenditure figures.

SENATOR SARBANES. Those figures were just private investment?

DR. SOLOW. Those were just private.

SENATOR SARBANES. So, we may also lag behind them in public investment?

DR. SOLOW. We may, very well, although I do not know that without looking at the data. I suspect we do, especially if you do not count the nuclear submarine as public investment. If you look at infrastructure-like public investment, I suspect we have been spending less than our industrial rivals. But I do not think we should guess about that. I think we should see what we can do about getting some figures.

SENATOR SARBANES. Thank you, very much.

SENATOR SARBANES. Thank you.

REPRESENTATIVE HAMILTON. Thank you for coming, Paul.

DR. SOLOW. So long, Paul.

REPRESENTATIVE HAMILTON. You mentioned in response to Senator Sarbanes' comment that you thought well of the idea of the consumption tax. Do you see that as a replacement for income tax in some degree? Or in addition, thereto?

DR. SOLOW. Well, I was not anxious myself to get into this question, but since you asked, sir, I will tell you what I think. Every time you look at data compiled on effective tax rates across industrial countries, the United States turns out to be at the bottom of the list, along generally with Japan and maybe Switzerland. We are not, by the standards of the rest of the world, an overtaxed country. We may be an overtaxed country by the standards of our own feelings, but by the standards of the rest of the world, we are not. I would not be hostile to raising some additional federal revenues through taxes that bore most heavily on consumption. I hasten to say I do not think that 1991 is the right time to be imposing extra taxes on an economy that is obviously not strong. In the first instance, I was trying to stick to revenue-neutral changes.

My own inclinations—but then I am not proposing to run for office—would be for a little more public revenue.

REPRESENTATIVE HAMILTON. One of the things I want to get from you is an overall assessment that you have of the American economy.

Are you satisfied? Are you frustrated with its performance? Are we falling far below potential? Do you think we are doing pretty good? What is your sense of it, overall?

DR. SOLOW. Let me say, first, that in judging the performance of the U.S. economy, I think it is not quite right just to compare its rates of growth with those of Japan or other countries. We started after the War in the 1950s, far ahead of everybody else, a lead that we could not hope to maintain. It is no surprise that the rest of the world is catching up.

Somehow you have to ask, given the fact that Europe and Japan were bound to gain on us, have we conducted our part of the race in a satisfying way?

There, I think the answer that comes clearly to me is, no. We have given up too much too fast. You see that in the stagnation of real incomes. There is just no reason why that should be so. You see it in a much less well-defined way just in terms of what looks like the dynamism of industry.

I am not now so much concerned with how much of our current potential we are using, or whether we should be happy or content to drag along at 6 or 6.5 percent unemployment rates and count ourselves prosperous. I am trying to think more about how rapidly we are improving the standard of living, and that means the productivity, of the American economic machine. I think we are not doing as well as we ought.

REPRESENTATIVE HAMILTON. Well, let us talk a little bit about productivity. Some of your predecessors in these conversations have focused on that a lot. The productivity rate is quite unsatisfactory.

DR. SOLOW. Yes.

REPRESENTATIVE HAMILTON. I think some of the things you mentioned obviously have a bearing on that.

But if you were to just address yourself to the question, how do you get the productivity rate up in this country? How would you respond, briefly?

DR. SOLOW. The shortest possible response I know is that the only source of productivity increase is investment, provided you interpret "investment" broadly so that it includes not only bricks and mortar, not only plant and equipment, but also human capital and knowledge.

The only way we know, other than to sit and wait to be lucky, is to devote resources to making things better in the future rather than consuming them now.

REPRESENTATIVE HAMILTON. Okay. Then, you make the suggestions that we invest in infrastructure; we invest in R&D; we invest in education; we invest in worker training, and so forth.

Give me some sense of the priorities of those investments in terms of getting productivity up.

DR. SOLOW. This is one of those cases where I want to say everything simultaneously, but let me try to make myself clear.

I think the place to begin, but only to begin, is with human capital and research and development.

Why? Because those are the areas in which there is every reason to expect a profit-driven, private economy to underinvest. Business firms capture a bigger part of their return on their plant and equipment spending than they do on the little that they spend on training workers or on the research and development spending that they undertake. So, I would start, I think, by timing to produce a more skilled work force and more technologically usable knowledge.

I think that plant and equipment is important, too, but you asked me for priority.

REPRESENTATIVE HAMILTON. Right. And of course when you are talking about improving human resources, you are talking about quite long lead times, are you not?

DR. SOLOW. Well, no.

REPRESENTATIVE HAMILTON. You are not?

DR. SOLOW. No. The business I am in, to the extent it is a business, is producing Ph.D.'s. A couple of them are here in the room. It takes, depending on when you begin, but beginning at the start of a college education, it takes 8 or 9 years to produce a Ph.D.

It does not take 8 or 9 years to start with a 17-year-old and produce a 19-year-old skilled craftsman or craftswoman.

There might be a long lead time in actually deciding what you want to do and organizing the country to do it, but I do not think that the process itself is very long.

REPRESENTATIVE HAMILTON. One of the things that struck me as you were talking about the labor point in your opening comments was that you put the emphasis on the transition from school to work, and you identified the German system as a model.

Does that suggest that you are satisfied with the product of the school system?

DR. SOLOW. No.

REPRESENTATIVE HAMILTON. I want to emphasize——

DR. SOLOW. I am not satisfied with the product of the school system at all.

My suggestion was to begin with the school-to-work business for two reasons.

First of all, because it would be the quickest way to upgrade the entry-level workers in American industry.

Second, I have the hope that if, at the end of the school-plus-vocational-education-system, there was a decent job, and if it were clear that the road to that job involved knowing how to read, knowing how to do arithmetic, that would provide needed motivation for improvement in the conventional parts of the education.

REPRESENTATIVE HAMILTON. I know you want to focus on the medium term, as you said, and most of your remarks were directed there ... and we are being joined now by Senator Bingaman.

Jeff, we are glad to have you.

SENATOR BINGAMAN. Sorry I am late.

REPRESENTATIVE HAMILTON. No, no. We are having a good discussion.

But right now, what should we do? You have this extraordinary disagreement among economists about whether or not we are coming out of the recession. Most of them who have appeared before us have used the word "anemic recovery," which I guess stands in some contrast to the way we have come out of other recessions with a lot more vigor. What do you think we should do right now?

DR. SOLOW. I was hoping to avoid that, sir——

[Laughter.]

DR. SOLOW. ——so, I lose——

REPRESENTATIVE HAMILTON. Well, politicians always have to look at the very short term.

DR. SOLOW. I understand that.

First of all, I agree with the diagnosis of the anemic recovery. To see the order of magnitude, in the average postwar recession, the first year of upswing has increased real GNP by something like 6 percent, and the people who are in the business of forecasting a year ahead suggest that we will be lucky to get 3 percent out of this one. So, it is about half as lively as we have come to expect.

What ought to be done right now depends on what you believe about why that is happening. It seems to me—and here, I have nothing to say that other people would not have told you—that a good part, but only part, of the problem is on the credit side. It is in the fact that banks are scared stiff, given what they had already lived through, that there has been a lot of overbuilding in the country.

REPRESENTATIVE HAMILTON. We have really got a credit crunch.

DR. SOLOW. Especially for construction, shopping centers, office buildings, you have a credit crunch from both sides. You have lenders who are looking at their balance sheets and are scared stiff about lending. You also have a real estate development industry that knows that there is a big overhang of empty office space. I do not think that there is any quick fix for that.

You could press the Federal Reserve to provide a lot more liquidity for the banking system. I do not think that that would result in a big increase in productive lending, and it might lay some dangerous groundwork for the future. But you could press the Fed to supply a bit more liquidity, and see what happens. But I do not have a lot of hope.

REPRESENTATIVE HAMILTON. Would you lower interest rates?

DR. SOLOW. My own view is that interest rates could be lowered safely in the United States.

I would point out, and I guess other people must have said to you, that for the permanent health of the economy, it is long-term interest rates that we want to get down. All that the Fed does in the first instance is push down short-term interest rates. We have seen short-term rates come down by 200 basis points and long-term interest rates come down by 30 or 40 basis points, not a big help.

REPRESENTATIVE HAMILTON. And on the fiscal side, it is important to get the deficit down.

DR. SOLOW. It is important to get the deficit down, with the right timing. If it is part of our policy to generate more investment in the United States, then eventually it must be part of our policy to generate more savings in the United States, and the deficit is an unproductive use of savings.

REPRESENTATIVE HAMILTON. Now, I want to get a little bit more into this question of the role of government in promoting greater productivity—and I know that Senator Bingaman knows a lot about this topic and may want to pursue it further—but you said we need to direct federal policy toward civilian industry.

You want to move some of the military R&D toward the civilian sector. I was not entirely clear on how you responded to some of Senator Sarbanes' questions on this. I also got the impression from you that you have some concerns, because you said for example that you did not want government micromanagement. I want to develop that process with you a little bit. How does this work, now?

We appropriate blank number of dollars for civilian research through some kind of a new government agency or through DARPA.

Then, how do we spend that money? This was what we used to call "industrial policy," and now they talk about "technology policy."

Dr. Solow. Yes, but—

Representative Hamilton. "Industrial policy" is a bad word.

Dr. Solow. I think there is something more than pure verbal difference here.

There is certainly some cosmetic use of language going on, but I think that there is a real difference, and I want to explain that difference.

The fundamental reason for government money to be spent is that the Legislative and Executive Branch is convinced that less than the best amount for the interests of the country is being spent on some object.

The trouble with industrial policy is that it asks some agency of the government to come to the conclusion that too little money is being spent on investment in the television assembly industry, say, and too much perhaps is being spent in the textile industry. That is not a judgment that a government agency is going to find itself competent to make.

The point about technology policy is this: I think that there is very good analytical reason to believe that a market economy—a capitalist economy as a whole—will spend less on research and development than is socially desirable.

Any textbook you can find will agree to that.

There are activities—not industries, but activities—that cut across industries that a market economy does too little of, like R&D, and some that it does too much of, like pollution, for reasons that are very well understood.

I think there is a case for saying that government funds should be spent on promoting R&D.

Now, you ask, "promoting R&D where?"

Representative Hamilton. Yes.

Dr. Solow. And the answer I give to that question is that what you want is a system in which it is not the agency alone that makes that decision, but some kind of competitive process in which industry has to participate. So, if the National Science Foundation, or a new branch of the National Science Foundation, or DARPA, or some other agency has some money to spend on civilian R&D, it does this by announcing a request for proposals.

We are going to judge these proposals on the basis of their intrinsic merit, and especially on how much the proposer is prepared to invest of its own money in this.

We are not going to do the whole thing. We are not going to give industry a free ride. We are going to say, if you have something that you want to do and you are willing to put some of your own bucks up, and you make a good case that this is a useful thing to do, we will contribute.

REPRESENTATIVE HAMILTON. Are you worried that a Senator from New Mexico, or a Congressman from Indiana will—

DR. SOLOW. You betcha I am worried.

My next sentence was going to be: The thing to be avoided here, at all costs, is that such funds are allocated by State, by Congressional District. That is exactly what I meant by "micromanagement," exactly.

REPRESENTATIVE HAMILTON. That is what I thought you meant by micromanagement.

[Laughter.]

DR. SOLOW. And I thought I was communicating. How can you avoid that?

Well, I think the only way that you can avoid that is by trying to insulate the agency from congressional/senatorial pressure. You do that by first allocating funds on something better than a year-to-year basis; by appointing and having its ultimate decision-making body be people who are not beholden to the congressional sponsors.

REPRESENTATIVE HAMILTON. Insulate it as much as you can from those political pressures.

DR. SOLOW. Yes.

REPRESENTATIVE HAMILTON. I have some more questions, but I will turn to Senator Bingaman.

SENATOR BINGAMAN. Let me just ask one question that is quite related.

Everyone says the government should not have an industrial policy.

From my perspective, it is very rational for governments in industrialized countries to support the application of technology in the manufacturing sector. If that means a manufacturing extension program, then that is what that should be.

One of the things that we have in this year's defense bill ... I just came from a meeting with your Congressman, Mr. Mavroules, where we are trying to see if we can keep this in there, but we are essentially trying to begin to put significant federal dollars into support for manufacturing extension programs, which are established at the state and local level, and that are intended to help small- and medium-sized businesses to modernize their production.

It seems to me that one of the major failings of our economic policy in recent decades is that we do not seem to have had any concern for the loss of our manufacturing base.

We have had no policies or programs in place to guard against that lost manufacturing base and, accordingly, a lot of it has deteriorated.

I would be interested in your views on that.

REPRESENTATIVE HAMILTON. Excuse me. May I interrupt? I have a vote in the house, Jeff.

I will run over and be back in 10 minutes or so. Is that all right?

SENATOR BINGAMAN. Certainly.

REPRESENTATIVE HAMILTON. Excuse me, Dr. Solow.

DR. SOLOW. Thank you.

Senator Bingaman, when I made my introductory remarks, I, in fact, mentioned that the model for the sort of thing I had in mind was the Agricultural Extension Service. The concept of a manufacturing extension service fits in exactly with the sort of thing I had in mind. I even went so far as to say that I thought that small- and medium-sized businesses were exactly the place that the government ought to be placing its bets because nobody else is placing any bets there. So, I think that that is exactly the right sort of thing to do.

I have a gut sympathy with the feeling that we ought not be calm in the face of the loss of the manufacturing base. I put it that way because it is surprisingly hard to find a good intellectual justification for distinguishing between manufacturing and financial services, or some other sort of service.

I have placed my mind, such as it is, at the service of my gut, such as it is, and I think that one can make a sound case that manufacturing has some special qualities. For instance, if you lose the manufacturing base, you are sure to lose those services that serve manufacturing.

I read in the newspaper a month or so ago of a proposal that we could have a computer industry without a computer manufacturing industry just by specializing in software. I think that is probably, in principle, right; but I think that in fact it could not be done; if you lose the computer industry, the software services are going to migrate with it, to be with it.

Second, I think you can make a case that manufacturing machinery, whether it is computers or metal-working machinery, is the vehicle by which technological progress sifts into the using industries. We had better continue manufacturing equipment.

So, I conclude, anyhow, that I really do not want to lose that manufacturing base. But the place where I stop is exactly the place where someone says, well, we have a choice of investing in shoe manufacturing or investing in starter-motor manufacturing. Which should we do?

The answer to that is: I have no way of knowing. The knowledge that that depends on is sitting out there at the end of the line.

I think one fundamental reason why the Eastern European/Soviet economies have collapsed, apart from the fact that nobody wants to live like that, is that they tried to centralize decisionmaking too much. The manufacturing extension service, apart from providing services, might even have a branch that could provide bucks. But it would provide bucks for people who were willing to invest their own bucks, and not for people who just say, "you have bucks to provide, I am here to take them." You have to put something on the table, yourself.

Senator Bingaman. Let me just describe to you, two initiatives. Dorothy Robyn has worked real hard on these, and we have got them both in the Defense bill.

One of them is to get federal support for a national manufacturing extension effort, which would be generic. Any small- and medium-sized manufacturing firm—you would not give assistance directly to the firm in the way of funds—would be given assistance to manufacturing improvement, or manufacturing productivity centers that would then provide the assistance.

So, that is one, and I think you have just addressed that.

DR. SOLOW. Yes.

REPRESENTATIVE HAMILTON. The other is something that we have called "critical technology application centers." What we have tried to do there is to say, okay, the Federal Government is not very good at choosing the shoe industry over the refrigerator industry, but there is not a lot of dispute about those areas of technological development that hold promise for us in the coming decades.

I mean, there is general agreement that microelectronics, advanced materials, those types of things, are areas of concentration and of great opportunity. Maybe industries will develop from them, and maybe they will not.

So, you identify some areas that you can get agreement on that are critical technology areas for defense and commercial needs. Then, you say that in those general areas of endeavor, where we have a cluster of industry firms that are trying to find ways to develop those technologies and apply them and that allows them to be world class competitors in new industries, it is not government coming in and saying here is a bunch of money; go see what you can do with it. I think our proposal is that the private sector has to put in 40 percent; the state and local government has to put in 30 percent.

Somebody else who is willing to participate at the local-regional level has to put in 30 percent, and then the Federal Government would come in and add the other 30 percent to support the further development and application of that technology for that industry cluster.

It is building a little bit on some of the stuff that Michael Porter has identified in his book on the comparative advantages of nations, where he has, I think correctly, pointed out that industries are world-class, not because they are in a particular country, but because they are in a particular location where there are a lot of factors that keep them very competitive.

So, that is another way of getting at it.

Does that make sense in your view, or not?

DR. SOLOW. Yes. That makes a terrific amount of sense to me.

I would add one proviso, however. I am not so sure that that system ought to be limited to some initially described list of critical technologies.

I will go for it anyway because I do not think we can go wrong with microelectronics. Everyone knows that that is going to be a source of industrial products for some time in the future. But I think that when you sit down and try to list the critical technologies, it would be better if there were some way for that industry cluster out there to contribute to the list. They know what they need, or they may know even better than the local engineering school will know.

And if they were able to say it is not carbon fiber materials that we need, what is really our hang-up is that we do not know how to fasten those things. What we really need is somebody to work on that problem. Then, that would be even better.

SENATOR BINGAMAN. Well, I hear that point and it is a good one.

I think that as a practical matter it is not a problem because the categories of the labels that are stuck on these critical technologies are sufficiently broad, and it is relatively easy for a company to come along and say this is clearly under this category.

DR. SOLOW. That is fine.

SENATOR BINGAMAN. It is not limiting.

DR. SOLOW. I like that a lot.

What I am afraid of, as you gather, is that buzz words tend to dominate lists like this, and you do not want to be limited to those things.

I think there is a lot to be said for some kind of local self-help.

I smiled inside when you said "clusters," because I think that is the key thing. It is not the isolated firm. It is a little industry. It is all those parts' suppliers in Michigan, or something like that. It is good to get them together with their state and local governments, with the University of Michigan, Michigan State, and so on, and have them figure out what it is they need, and communicate that to the critical technology center, if that is it.

There is a system like that that has been working on a very small scale, mostly with state money, in Pennsylvania.

SENATOR BINGAMAN. That is the model we essentially are trying to pick up.

DR. SOLOW. I think that is a very good model, and I would be delighted to see some federal money put in there.

SENATOR BINGAMAN. We are doing our best.

DR. SOLOW. Thirty percent is a good, round number.

I mean, I cannot tell you that it is better or worse than 33 percent, but it is the right order of magnitude. Although right now, I must say, to get money out of state and local governments is a little bit like squeezing blood from stones. Maybe in a couple of years it will be better. Nevertheless, I think that is a good idea.

SENATOR BINGAMAN. What do you—and again maybe this was in your initial comments before I came in—but my inexact understanding ... Let me see what I have here.

DR. SOLOW. You have Mr. Podoff there.

MR. PODOFF. I am only a messenger.

[Laughter.]

SENATOR BINGAMAN. Okay, let us see.

[Pause.]

Yes, I wonder if the views that you expressed about the book, *Manufacturing Matters*, had been changing on this issue over the last few years. Your concern about the problem of our losing our manufacturing base, has there been an evolution in your thinking on that?

Dr. Solow. I would like to say yes, because it would make me feel younger to think that I am evolving, but in fact I do not honestly think that my opinions have changed a lot on this in the last 7 or 8 years.

I think that, in general, people, economists and others do tend to make a sharper distinction between manufacturing and services than is justified. I may have said that in the past. I still think so.

From the very first time I ever heard the phrase "post-industrial economy," I laughed because I cannot imagine what a "post-industrial" economy would be.

For instance, to take this down to elements, there is no way that we could sell services abroad enough to pay for our manufacturing imports abroad if we did not have a substantial manufacturing sector ourselves. The figures could not add up.

I already mentioned a few minutes ago that I think that manufacturing industry provides a transmission belt for technology from equipment manufacturers to equipment users; that is very important.

So, I do not honestly think that I have changed my mind a lot.

It was only when I got roped into a study at MIT that started 3 or 4 years ago—Congressman Hamilton mentioned it at the very beginning—that I began to have to think about this again in a serious way.

Senator Bingaman. One follow-up, and then, Lee, I have had a good chance to ask questions while you have been gone, so I will just ask one more.

Representative Hamilton. Go ahead.

Senator Bingaman. In light of the importance of manufacturing as something we need to maintain the capability for, when you look at our trade relation with Japan, the glaring problem that strikes me—and I guess strikes everybody—is that we cannot sell them manufactured products. Not only we cannot, the Europeans cannot.

I guess, what, 3 percent of the manufactured products used in their society are from imports, whereas it is 15 or 20 percent here, and the same thing in Europe. That seems to me to be a problem that we cannot just continue to ignore indefinitely. We have ignored it now for a decade, but at some stage do we not have to do something in our trade policy to deal with that, other than continuing to preach free trade.

Dr. Solow. I find this an excruciatingly difficult policy question, and I would like to explain why.

My reading of the situation is exactly yours.

I think that the Japanese, in particular, and possibly some other countries as well, and possibly Europe, more in the future than in the past, have managed in subtle ways to close their economies to manufacturing imports.

Few things have amused me as much in a sad way as the spectacle of American delegation after American delegation going off to Tokyo to negotiate on opening up the Japanese economy, and to return four weeks later announcing that they have sold so many additional bushels of citrus fruits to Japan.

The question is, what you do about it.

It is easy for me to say that you negotiate harder and tougher. I could say that, but I do not really have any concept of what it means.

What makes this difficult is that it often comes down to the question: should we protect our own manufacturing as revenge, as response to this? I do not like that answer because it sends the wrong signal to our own manufacturing industry. Any time you protect a domestic industry, you allow it in principle to stay a little soft. I do not like that.

One might hope that you could threaten protection without actually doing it. I wonder about that, because I confess that my wife and I raised three children on the principle of the idle threat. If you don't do this, we will do this terrible thing to you, and it worked. We never had to carry out the terrible threats.

It may be that Japan plays harder ball than our children played, and I would not like to contemplate carrying out the threat. I do not know what to do there.

One thing that has suggested itself is to say to the Japanese: we do not care what you do, but there are certain minimal results that have to come from your actions. You choose the actions. We want the results.

I am tempted by that because I do think this is a serious matter, but I resist very much—actually having to make good on the threat and protect American manufacturing industry, which could do a lot better on its own. If you take away the stimulus for them to do better, you may be harming longer run prospects.

That is a very unsatisfactory answer, but that is because my state of mind is very unsatisfactory on this. The problem is there. I do not like the only real solution that presents itself.

SENATOR BINGAMAN. Thank you.

REPRESENTATIVE HAMILTON. How much do you worry about inequality of income distribution?

DR. SOLOW. I wrote my Ph.D. thesis in, I regret to say, 1950 on the subject of inequality in income distribution, and I worry about it a lot.

My diagnosis of the increasing inequality of the income distribution comes in two parts, both of which call out for some kind of remedy.

The easier part is, we have over the past 10 years or so rejiggered the tax and transfer system in the United States so that it systematically favors higher incomes against lower incomes, and I would like to find a way to reverse that.

There is a deeper problem that I want to mention, which is the second part of my response.

My belief is that a large part of the increasing inequality of the income distribution in the United States comes from the fact that economic evolution systematically favors highly skilled people against people without skills.

One of the reasons it does so is that, in an open-trading world that I would not want to give up, unskilled people in the United States are competing more and more directly with unskilled people in Asia, in

Korea, on the Chinese mainland, in Latin America, and elsewhere, where what is abject poverty in the United States turns out to be an okay standard of living compared to what they are used to.

So, by building an open-trading world, we have placed unskilled people in the United States in direct competition with people who will work for much less than we want to see Americans working for. I think it would be a heartless and unwise policy to say, well, we are not going to let people in Latin America or China sell products that are cheap because they work for very little.

I think the much better policy—and that is why I focused on secondary and immediate postsecondary education—is to produce better skills in our own people. I think that both of those forces are at work.

REPRESENTATIVE HAMILTON. In identifying fiscal stimulus for investment, you hit upon the investment tax credit in your opening comments, and I gather you think that that is better than a capital gains tax reduction?

DR. SOLOW. Yes.

REPRESENTATIVE HAMILTON. Or any other incentive?

DR. SOLOW. Well, I will not say "any other incentive," because there may be cleverer things that I have not heard of.

I think that the proposal for reducing the tax on capital gains is a bad proposal for three reasons. The first reason is that it obviously is not going to happen. The second reason is, this is not a time to make yet one further transfer of income from poor people to rich people. But the third reason is the technical reason. All of the research that has been done on this question suggests that favoring capital gains in tax treatment is a very inefficient way of producing the kind of investment we want. It is too unfocused. So, you are buying very little stimulus for this inequitable transfer of income.

REPRESENTATIVE HAMILTON. And you are talking now about applying it to net investment.

Does that add a layer of considerable complexity in the administration of it?

DR. SOLOW. It adds some complexity. Everyone knows that the accounting measures of depreciation, and therefore accounting measures of net investment spending, have a large amount of convention in them. But we already have the figures for tax purposes. So, I do not think it would be very difficult to use them for this purpose.

REPRESENTATIVE HAMILTON. On the general level of unemployment, I would like you to direct your thoughts to the question of what policies you would pursue to get unemployment down without pushing inflation up.

In some ways, from my perspective, we have solved the unemployment problem by redefining "unemployment," and what is an acceptable level of unemployment.

Today, we have 6.7 or 6.8 percent unemployment. That is a lot of people out of work in this country.

DR. SOLOW. It sure is.

REPRESENTATIVE HAMILTON. What do you do to drive that unemployment rate down without jeopardizing other worthy economic goals?

DR. SOLOW. This is something that I have been thinking about for 30 years without ever coming to the neat answer.

First of all, I agree with you. I cannot abide people who say, well, the national rate of unemployment is 6.5 percent, so we just have to live with that. I do not like it. Not only do I not like it, but I think it is an argument—even when it comes from high places in the economics profession—that is based on flimsy theory and flimsy empirical verification.

My reading of the situation is that when the unemployment rate was 5.5 percent in 1986 or 1987, whenever it was, life was not so bad. There was no runaway inflation. There was some small acceleration of wage increases, but it was small, and there seemed to be nothing there to indicate that it was going to get out of hand, that it was going to continue to accelerate. So, my reading of the experience of the second half of the 1980s is that we could move the unemployment rate down toward 5.5 percent, as long as we do not do it too fast, but try to make continuous progress. That way, we could reemploy a million-plus people, whatever it would be.

Should you be happy with 5.5 percent? No, but I think you do have to recognize that we do not know very well where the safety zone is. You should keep pushing and experimenting, but not too suddenly.

I think it would help to have a larger number of well-trained people in the labor market.

REPRESENTATIVE HAMILTON. I am in a situation now where we have a series of votes, so I am going to have to conclude.

Do you have anything further, Jeff?

SENATOR BINGAMAN. No, I have really asked all I can think of.

REPRESENTATIVE HAMILTON. Let me ask you one other quick question.

The JEC has had an ongoing interest in the quality of economic statistics. We would just like to get your impression.

Have they deteriorated lately? Do we need to put more resources into improving the quality?

DR. SOLOW. I think that we ought to be putting a small amount more into improving quality, but I want to redefine "quality" a little bit.

Since I look at international statistics quite a lot, I am very conscious of the fact that we do very well by the standards of other countries. I think that the people who do the work in the Bureau of the Census and the BLS are top-notch and have great integrity, and we are very lucky to have them. What I find more and more is that, as the problems get subtler and the conversation we have had today suggests that a lot of them are subtler, there are no data for some of the questions we would like to ask.

I think always watching the quality is a good thing, but I would like to see a few resources put into freelancing and saying, what are the questions we need to answer for making economic policy? What are the questions for which the data are lacking? How could we go about collecting those? I think that is almost more important right now than shear quality.

REPRESENTATIVE HAMILTON. We thank you, sir. It has been a stimulating morning. We thank you for joining us, and we stand adjourned.

SENATOR BINGAMAN. Thank you.

DR. SOLOW. Thanks a lot.

[Whereupon, at 11:40 a.m., the Committee adjourned, subject to the call of the Chair.]

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