AN ALTERNATIVE TO REAGANOMICS

A. E. Kahn
Cornell University

My job is to present an alternative to Reaganomics. As for the question of whether you're going to find me 180 degrees in opposition to Reaganomics, how can you be 180 degrees in opposition to somebody who is himself facing in four different directions? Reaganomics includes the so–called supply siders, who contend that reductions in taxes will induce such a burst of activity that there will be smaller deficits rather than larger ones.

I suspect they have by now burned the napkin on which Arthur Laffer drew his famous curve. Reaganomics also embraces the monetarists, whom supply siders despise, who argue of course that you simply have to have a fixed monetary rule to solve all problems in the economy. Reaganomics also embraces the President himself, who for 20 years had said, the source of all inflation was government deficits. It also embraces the supply side people who say government deficits are nothing to worry about. Reaganomics embraces the President's insistence that we should never raise taxes. And Reaganomics argues that we must pass an amendment to the Constitution so that we can never again have a government deficit. How many more directions can one go simultaneously?

It seems to me we have to try first to diagnose our present position before we try to prescribe. It's clear that the simplest way of characterizing the chronic problem of the American economy is stagflation. It's the same problem we've had for something like 15 years at least. Sometimes it's more "stag". Sometimes it's more "flation" and we always knew that the more you were willing to have "stag" the less "flation" you would have. The more you were willing to tolerate "flation" the less "stag" although that's no longer so clear. If there were time I'd be very happy to talk about that.

There are interesting and alarming similarities in the current indexes to the way things were six or seven years ago. In 1976, the CPI particularly went up 4.8 percent after having reached double digit levels (12.2 percent) during the first OPEC price explosion in 1973-1974. In the first seven months of this year the CPI went up at an annual rate of 5.4 percent — very similar and down from the double digit levels. Unemployment has reached 9.8 percent. It appears from the latest figures on industrial production and new claims for unemployment insurance that it's going to go over 10. The last time we had a level corresponding to that was May 1975 when it was 9.0 percent. Thus we must ask if we've solved the problem of inflation now did we really solve it then? We can't give a direct answer to that.

The present condition of the economy is a depression that is very largely induced by monetary restraints which are aimed at stopping inflation. We simply have not demonstrated that we have discovered the key to solving the inflation problem without causing significant and serious unemployment. The fact is right now no one would maintain that we have excessive aggregate spending in our economy. On the contrary, aggregate demand is inadequate to give us something like full employment. Still the underlying rate of inflation is about 6 percent.

We really ought to ask why are prices and wages going up at 6 percent per year when we have inadequate total demand? There seems to be kind of a conflict here. Just as in 1975-1976 a tremendous amount of the cooling off in prices has been among those with an energy component and in food as you know. In the course of 1981, prices at the farm not only slowed down the rate of inflation but went down 12 percent. The same thing happened in 1976, contributing to that improvement in the inflation picture. And raw material prices always go down just the way farm prices go down. The key question is what happens when we turn around and begin to come out of recession.

It's still a little bit hard to understand how wages and fringes seem to be going up at about 6 percent per year in recession. Now that's an improvement over the 9 1/2 percent that they were going up in 1979 and 1980. With some normal resumption of productivity, that means that unit labor costs may be going up at 5 percent per year. Ask yourself why are they going up at that level? One reasons is the givebacks in basket case industries. Steel is the outstanding example of an industry that has suffered from an extraordinary explosion of wages over the last 10 years. Wages have increased about twice as rapidly in steel over the '70s as in industry, generally. Even when the industry was operating at 50 percent of capacity we had a new steel contract that gave something like 9 percent increase in wages per year. Productivity has been going down; our international competitive position has been deteriorating and still steel wages were going up.

The wages/productivity issue seems to be chronic and that's the kind of thing we have to aim our policy efforts toward. I suppose I have to ask the question about why our economy seems to have this chronic tendency to inflation which in turn then requires recession to cure it. There's a whole variety of explanations. For example, I was on Good Morning America a couple of months ago and talked about the problem of wage settlements and the tendency for prices and wages to creep up even in the face of inadequate total demand. Milton Friedman was on the next day — he said Professor Kahn is wrong — inflation is simply a consequence of excessive expansion of the money supply. Well in a sense he's perfectly right because that statement is tautological.

I don't know any economist who doubts that you could not have continued inflation but for it being validated or made possible by sufficient expansion of the money supply and sufficient aggregate spending. I don't know anybody who doubts that if you hold on sufficiently resolutely to the growth in the money supply there'll be some slippage, first of all because you can't define clearly what money is.

Somebody at the Bank of England once observed that the minute you select something as your definition of money as your policy variable it automatically becomes wrong, because that's the thing that people will economize on and they'll find other kinds of monies. No one really doubts that if we were to hold on tightly enough to the growth of the money supply and sufficiently control spending that it would bring inflation under control. But the critical question is what happens on the other side of the equation? What will the cost be? How long would you have to have a recession? How much unemployment in order to bring these things under control?

My own explanation or perhaps my description of inflation is that it rises out of a tendency in our modern, advanced democratic capitalist society for the people to demand and expect a long list of claims or entitlements. We organize into economic groups to assert influence in the marketplace and into political groups to assert influence at the political level. We insist on a share of the pie or a nonshrinking share even if the total pie is not increasing.

I think such an explanation is useful because the traditional economic explanation of inflation was simply, too much money chasing too few goods and too many expenditures pressing against the limits of supply. It's obvious that you can't very well use that as an explanation in view of the current slump in aggregate demand. But if you recognize all the variety of claims we make on our economic system, we may be able to understand our inflation somewhat better. Such a list follows.

Claims Exerted by an Entitlement Society

1. Credit financed consumption
2. Demands for government expenditure and public projects
3. Off budget preferential claims on resources
4. Government regulations which require private sector expenditure for social protection
5. Protection against competition
6. Tax preferences
7. Maintenance of income shares regardless of productivity

1. **Credit financed consumption**

We've become a consumerist society. Consumer debt in the last 30 years has increased more than twice as rapidly as personal disposable income. Mortgage debt has increased about 50 percent more rapidly than aggregate disposable income. Notice the general feeling of entitlement. Every year we need a bigger house than the year before. When interest rates rose, people besieged us and said, "How can new kids coming out forming new families, afford to buy a new house?" Most of us are not aware that the average size of a house has increased over 75 percent in the last 25 years. The average size of a lot has increased over 80 percent. The percentage of new houses with two bathrooms or more has gone from 2 to 3 percent to over 75 percent. To obtain this kind of lifestyle we have turned to a credit financed expansion of consumption.

2. **Demands for government expenditures**

To recognize that government expenditure is a problem requires only to think of the problem we're having in bringing the budget under control. There may be differences of opinion about how important government expenditures are as a source of inflation. I happen to be one who feels that it is popularly exaggerated. Nevertheless, it is one way in which we collectively exert claims on the economy via government expenditures of all kinds from defense to food stamps.

3. **Off budget expenditures**

Perhaps even more insidious and also a reason why the balanced budget amendment is so foolish are the claims on government for all sorts of things that don't get into the budget. Off budget assistance in getting preferential access to resources, loan guarantees in the scores of billions of dollars, interest free financing, and the support and full faith of the U.S. government as backing has become a regular approach in Washington. For the most part these proposals are perfectly legitimate things in principle. It is hard to be opposed to new hospitals or better bridges. I'm simply saying these projects add up to more than we are capable of paying for.

4. **Regulations requiring private sector expenditures**

Another type of off budget demand is for various kinds of protective regulations. The government doesn't have to put an appropriation in its budget to build sewer plants or to clean up the environment. It can simply impose regulations on businesses. We say you have to put in scrubbers, for example, no matter what kind of coal you're burning. Thus, billions of dollars of expenditures, which may increase the cost of energy 15 to 20 percent, use up real resources and they don't show up in the budget at all. The claim on the use of resources is still there. The imposition I'm talking about here is social protective regulation.

We organize ourselves to apply group pressure and then to regard these regulations as sacrosanct. We demand more, even though they are a claim on resources.

5. **Protection against competition**

There are various kinds of protections, like the kind of regulation that the CAB represented, which protect against competition. Notice that's another way in which interest groups lay claim to a protection of their ability to get a share of the national product.

The truckers recognize that the value of their certificates runs in the millions of dollars by keeping other people out. If a trucker carries oranges north from Florida, note the agriculture exemption, the truck has to come back empty. Rather than go empty truckers might look around for someone who has a certificate to loan so they can carry something back. Do you know what they'd have to pay for that certificate? It's 25 to 30 percent of their gross revenues. Just for that piece of paper entitling them to make the trip. Well, that shows the value of protections against competition. You want to buy a television station? You may be able to buy the equipment for $3 to $5 million but you'll pay $40 million or $50 million for the station. You want to buy a taxicab business in New York City? The cab may cost you $15,000. The medallion to drive it will cost you $60,000. And it is not just businesses but the wages of the workers, like the Teamsters and the airline pilots who benefit.

6. **Tax preferences**

Tax preferences of one kind or another have become an entitlement that nearly all enjoy to some degree. Just to insult all of you, stop and think about the tax break that is exemplified by the fact that you can deduct the interest on your mortgage from your taxable income. You might say well why not? Isn't interest a cost? Don't businesses deduct interest as an expense? Yes, but businesses also declare the income that is made possible from the assets that they acquire by going into debt. But you don't declare the income you receive from that house unless you rent it. Perhaps one could propose a reform and permit the interest deduction only on the first house, not the second, third, and fourth and only on the first $75,000 of the mortgage, not on the second, third, and fourth million. Obviously there are all sorts of tax breaks of one kind or another. We have come to take them for granted.

7. **Income shares**

Perhaps most of all, there is demand that wages must increase and that no one can lose position even if there is a loss in productivity. When productivity actually declined in 1979-1980, and in addition our country was subjected to an incremental impoverishment by virtue of the sharp increase in the price of OPEC oil on the order of $50 billion, there was no way in the world that the average income per person could avoid going down 3 or 4 percent. Output per person went down and in addition our terms of trade turned against us. We were being subjected to exploitation. At this very time there were some people in our economy, both in wage contracts and in government transfer programs, notably Social Security, who achieved absolute insulation. Because the CPI went up, they increased their money income share equivalently. The result of course was that the cost was imposed disproportionately on the rest of us.

If you accept some of these explanations, or descriptions of the recent inflationary process, then we must come back to thinking about possible alternative ways to deal with them. I'll list 10 different approaches to some of these issues and discuss them briefly.

Approaches to the Inflation Problem

1. Monetary restraint
2. Controls on government expenditures and transfer payments
3. Stimulate private investment
4. Encourage private savings, IRA's, etc.
5. Use of consumption taxes or VAT (value added tax)
6. Consider a wage-price policy
7. Change our collective bargaining institutions
8. Reduce government regulation of business
9. Consider costs of environmental regulation
10. Industrial policy and the role of government

1. **Monetary restraint**

Because there is an imbalance between supply and demand, some restraint is required on the demand side while we seek to improve productivity on the supply side. Whether or not you say that monetary expansion is the cause of inflation or rather that it accommodates inflation by permitting the expansion of expenditures, the money supply does have a role.

I think the lesson of the last couple of years is that you can't put all the load on monetary restraint either. That is one of the reasons that we have such a deep recession and provides some prospect that the monetary restraint will now be relaxed. There are really two reasons why long term interest rates are still so high. One is the fear that the Fed will not permit a continued rise in the money supply at present rates and that it will tighten the money supply for fear of inflation. The other reason is the fear that they will let go and permit the money supply to increase more rapidly and therefore bring on inflation. Paul Volcker — all 6 ft. 7 in. of him — is in a box. He's damned if he does, and damned if he doesn't. The main reason for all this is too much emphasis on monetary policy alone. Simultaneously, of course, we must recognize the looseness of fiscal policy. I agree with Dr. Horwich that a $110 billion deficit in the middle of a recession doesn't bother me a bit. But it is the prospect that the deficits will not go down that is a concern. The problem is that the whole burden has been thrown on monetary restraint and thus the prospect of big deficits holds interest rates up compounding the problem.

2. **Government expenditure control**

If monetary restraint is not enough, then we must turn to government expenditure control. But that is easier said than done. It sounds as though I'm really endorsing Reaganomics. Well in an important measure I am. But let me under the heading of government expenditure limitations suggest a number of ways in which I would disagree rather substantially with the program of the President.

First of all I think he has insufficiently distinguished government expenditures that are in the nature of investments from government expenditures that are in the nature of consumption. A real problem is the transfer programs which have increased from something like 26 percent of the federal budget 20 years ago to over 50 percent of the federal budget today. These are essentially mere transfers and essentially encourage consumption. All of them are highly desirable, care of our aging, care of government employees who retire, care of our military who retire, medicare, medicaid, food stamps. These are good things.

But it is important to distinguish government investments from government expenditures. It is irrational from the point of view of long run improvement in productivity that we are cutting our expenditures on research and development. How can we cut down on the National Science Foundation's program of science education? You've seen the horrendous figures on how few of our kids take calculus as compared with kids in any other country in the world. Our roads and our harbor facilities deteriorate. We could be the biggest coal exporting country in the world but we don't have harbors that are capable of handling the new, huge ships. Our bridges are falling apart as you're well aware. Expenditures on education, expenditures on job training, and investment in physical infrastructure should be expanded. These are investments in human capital of a kind that only government can make.

If government expenditure is to be brought under control the burden of restraint must be distributed fairly and equitably. That means we can no longer hold that Social Security programs must remain essentially untouched. Old age survivors insurance alone amounts to 20 percent of the federal budget. Social Security type programs including medicare and the like, amount to 28 percent of the entire budget. Recognize that military expenditures, which is increasing so rapidly, accounts for 30 percent of the budget. Recognize that interest on the debt is 12 to 14 percent of the budget. You don't have very much left if you won't touch these sacrosanct programs.

It's of some interest that there is a bipartisan recognition of this fact. People like Peter Peterson, former secretary of Commerce in the Republican administration, John Connally, William Simon, Mike Blumenthal and Henry Fowler, have issued a statement and asked me to their group, pointing out that we have cut programs directed on the basis of need two or three times as much as we have touched the programs that go to the great middle class. Sooner or later we're going to have to cut and do something about Social Security, which goes to people regardless of need.

Don't ever get the impression that Social Security benefits have not kept up with the cost of living. On the contrary, the average benefit to a Social Security beneficiary has increased something like 55 or 60 percent more rapidly than the CPI. People who are retiring today, regardless of need, are getting back three to six times the value of what they put in to the system including interest.

My own solution is to subject Social Security benefits, the noncontributed part, to an income tax. In that way you can take care of the truly poor, old people. But poor and old are not synonyms. I want to take care of poor old people just as much as anybody else. But a country cannot go on forever and subsidize the great middle class. When you try to subsidize everybody you end up subsidizing nobody and create inflation in the process.

3. Stimulation of private investment

Clearly on the productivity side there's a need for greater stimulus to private investment. There's no difference of opinion on this. The inducements in the 1981 tax bill were similar to the ones that were recommended by President Carter in the preceding year. Most people are not aware that we devoted about the same percentage of our GNP in the 1970s to capital formation nonresidential, business plant and equipment as we did in the 1960s and the 1950s. Perhaps more important we need to devote a couple of percentage points more of our GNP to private investment if we are going to resume growth and productivity in this country. Partly this is necessary to equip our ballooning labor force. It takes new investment to embody new technology.

The historic increase in output per worker has clearly not been unrelated to the fact that the amount of capital available per worker went up something like three percent per year decade in and decade out in our country. However, in the 1970s it slowed down to about one percent and then down to zero. Why? Because in part the labor force was increasing so rapidly. So, even though we devoted the same percentage of our resources to capital formation it was spread over a larger labor force. Now what we've got to do is put more of our GNP into investment, not less.

4. **Private savings**

Unless you find ways of stimulating an increase in personal savings to match increased investment you are going to have inflation. The provisions for IRA's and Keogh Plans are highly desirable and will provide over time much needed funds for investment.

5. **Consumption**

Some of the burden now placed on income taxes should be shifted to consumption taxes. We are the only major country in the world that doesn't have a value added tax, essentially a kind of excise or an expenditure tax. I notice that Gary Hart has been proposing the exploration of an expenditure tax. The way to make a VAT progressive is to combine it with a negative income tax such as Milton Friedman advocated for 10 or 15 years. An expenditure tax requires that individuals declare their income, capital assets at the beginning of the year and at the end of the year and the difference is consumption. Obviously the arithmetic would be more precise. Again you could have big exemptions, the first $10,000 to $12,000 per year to help with the progressivity.

6. **Wage-price policy**

I'm indebted to Dr. Horwich for having laid the intellectual ground work for a discussion of wage-price policy. The line between a wage and price policy and wage and price controls is important. There is an enormous temptation to go to controls but that doesn't work. A more general policy is not a very satisfactory system. Most of us are tempted to look at the so-called TIP (Tax-based Antiinflation Plan) in which you do not try to say what wages should be, you do not try to tell any business or any industry or any market what their prices should be. Instead, you simply try to lean against the wind by setting some sort of an average that is consistent with probable productivity advance. If wages exceed that average the business has to pay a penalty in taxes. If you pay less than that you get a rebate in taxes. If a large group of workers increases their wages more than productivity with a consequent deleterious effect on the economy, then we accelerate the wage-price spiral which brings about the inflation, which seem inevitably to mean a recession for all of us.

7. **Collective bargaining**

It is possible that changes in our collective bargaining institutions could provide some important assistance. At present no one wants to accept a lower increase in wages than the teamsters or some other union got. Teamsters were chasing the coal miners who got something like 40 percent the year before and the spring of 1981 the coal miners were chasing the automobile workers. No one wants to be behind. It is at least conceivable that if you had more of a centralization of the collective bargaining process with some sort of negotiation of standards covering the economy at large, you might get more responsible wage decisions. There are some people who will argue that if you eliminate industry wide collective bargaining you might reduce the possibility of playing one company against the other. I think there are more fundamental changes that have to occur in the attitude of labor and management.

Our labor movement has the view that its job is to get more and more. Unemployment from excessively high wages is viewed as the government's problem. Productivity, that's management's problem. Quality of product, that's management problem, too. If things get bad enough, there's got to be some recognition of a mutual interest in productivity and a mutual responsibility for product quality. The profit sharing element that helped save Eastern Airlines and that has just gone into the new Chrysler contract is a very hopeful sign. One of the reasons that the Japanese have less of a dilemma about controlling inflation by monetary restraint than we do is that a much larger percentage of their wages are in the form of shares in profits.

8. **Government regulation**

Certainly a greater reliance can be placed on the forces of competition that has been done. But getting out of the regulation business is easier said than done. It is natural now to ask government to step in and protect people from competition whenever they are threatened. In some ways the Reagan administration has done a good job, in some ways it's done an abysmal job. Establishing quotas on the imports of Japanese cars is precisely the governmental validation of the process that I've been describing. This is the problem of wages increasing more than productivity.

Higher and higher prices in industry that's not particularly concerned about price competition are passed on. Quality deteriorates; productivity goes down; and then when at last market retribution threatens and the Japanese cars come in, they turn to the government to protect them. Clearly we've got to try constantly to strengthen the discipline of the competitive market and not protect people against it.

9. **Environmental regulation**

Clearly there's an enormous need for more effective and realistic cost-benefit calculations in the field of environmental regulation and occupational safety regulation. At the same time you're not going to solve the problem by taking the job away from the zealots and turning it over to the philistines. Government does have a role in the process, but it can play it more prudently. In a unit like the Environmental Protection Agency professional standards must be given a chance to be established, with cost-benefit comparisons adopted as one basis for regulatory decisions.

10. **Industrial policy**

The role of government in industrial policy is a hot topic. Currently, there's a good deal of talk about the government setting up Reconstruction Finance Corporations to pick winners, to put money in particular areas to emulate the Japanese. I tend to be very skeptical about these proposals, because my fear is that in the United States we will use such capital to pick losers. We'll use it to bail out powerful industries, at the behest of such groups as the steel lobby and the United Steel Workers.

At the same time it seems undeniable that there are areas in which great benefits will accrue to the economy at large from specific assistance to particular industries. I don't know how many of you read the articles in the *New Yorker* about the aerospace industry and the problems of our competing in that area. But in the long run, the best industrial policy is the kind I've talked about of investing in education, in research and development, building our capacity for future productivity.

Well having given you my program for dealing with inflation and recession you will understand why I am in Ithaca, New York and not Washington, D.C. You know the critical question is a political question. Can we organize ourselves as a society to exercise the kind of discipline to restrain our demands to distribute our burdens fairly, and to recapture the secret of productivity? I don't know the answer to that any better than anybody else. But I think this is the kind of platform on which disinterested people can agree.

FEDERAL GOVERNMENT ROLE IN RESOURCE MANAGEMENT