A Politician's Perspective on Economic Theory

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I would like to consider why economic analysis does not seem to serve effectively the political system that must make economic decisions in the United States.

Let me start with deficit predictions. One would assume that such predictions would have some utility for the Congress in charting its fiscal course. However, they turn out to be very squishy. For example, when the 100th Congress convened in January 1987, it was told by the Congressional Budget Office that the Fiscal Year 1987 deficit would be $176 billion, but that over the next five years the deficit would gradually decline so that it would be $84 billion by 1992.

Now that did not sound too bad. Though both $176 billion and $84 billion were higher than one would like, the trend was plainly in the right direction. In short, one had the impression that the Gramm-Rudman-Hollings deficit reduction legislation was really working to put the deficit on a steady downward course.

However, when the Congressional Budget Office issued its mid-year report in early August, 1987, we were in for a rude shock. Though the predicted 1987 deficit had dropped to $157 billion – and in fact two months later it turned out to be $10 billion lower – the predicted deficit for 1992 was now $151 billion! It turned out that some very modest re-estimates as to economic assumptions made the whole difference as to the 1992 numbers. So instead of the steady decline in deficits that we were led to expect in January, we were now facing an almost total lack of progress in reducing the deficits. As I said, that was a shock, and that shock ultimately may have contributed significantly to the October 19, 1987, stock market debacle.

Perhaps if we had read the fine print, we should have been less shocked. For the Congressional Budget Office currently claims that, in January, it can predict the next year's GNP with only a two-thirds chance that it will ultimately turn out to be within 4.2 per cent of the estimate, this means that there is a two-thirds chance that the actual budget deficit will turn out to be within $49 billion of the estimate. In other words, there is a one-third chance the Congressional Budget Office will miss next year's target by plus or minus $49 billion. And for an estimate of a GNP five years down the road the CBO tells us there is a one third chance they will be up to $125 billion off the mark. That leaves Congress some real problems – to say the least – in trying to chart our fiscal course.

Up to now I have focused on the Congressional Budget Office, which tends to rely primarily on Keynesian econometric models in making its predictions. I have done so because we in Congress tend to start from CBO estimates in doing our work. That is not because we all agree with its econometric models, but because our budget discussions tend to become immensely more complicated if we do not start from the same baseline assumptions, so it is natural to begin with what our staffs are telling us, however great or little faith we may have in their estimates. Our alternative, by and large, is the Office of Management Budget estimates, and they have been no more accurate in the long haul.

But the fact of the matter is that other approaches offer us no greater assurances of accuracy. To demonstrate that, let me turn to early 1981 and the controversy over the first Reagan budget. Using supply-side analysis, the Reagan White House assured us that the Reagan budget and tax proposals would produce 4.2 per cent real growth in 1982. A couple of weeks later, the CBO, using its Keynesian analysis, told us the Reagan proposal would give us only 2.5 per cent real growth in 1982.

You will all remember that in 1982 we had the worst recession since 1937-38 – predicted by neither supply-siders nor Keynesians. Needless to say, experience has left us politicians skeptical of the ability of either supply siders or Keynesians to tell us in advance what impact a given Congressional budget will have.

In fairness, I should point out that both supply siders and Keynesians have come up with theories after the fact to explain what happened. The supply siders point out that we really did not have a tax cut in 1981 after all because of "bracket creep", the increase in Social Security taxes, and the increase in windfall profits tax revenues resulting from the decontrol of oil prices.

Both they and the Keynesians also point out that they did not anticipate that the Federal Reserve Board would slam on the monetary brakes as hard as Paul Volcker did in 1981-82. Perhaps that suggest that in addition to publishing the weekly money supply figures, the Fed should also administer a periodic Rorschach test to its Chairman and publish the results, so we could have a better means of following the state of his psyche. But the fact is that neither the supply siders nor the Keynesians were singing that tune in mid-'81 when the Reagan budget proposals were pending before Congress.

Now what I have just recounted might suggest that the third great school of contemporary economists, the monetarists, really have the answer for us. But on reflection I must say that I do not see them as offering a great deal of guidance to the Congress or the Executive Branch. In the first place, neither of us directly controls the money supply, though as the font of the Federal Reserve System's powers the Congress could exert far more control over the money supply than it has chosen to do. I hasten to add that I do not recommend that.

But even if we chose to direct monetary policy more closely that we have, the vast upheavals in our financial system have made monetarism extremely difficult to use as an economic management system, whatever its value in analysing what has happened in the past. The first difficulty is that there is little agreement as to what is "money" for purposes of monetary theory. The second difficulty is that there is little agreement as to what the time lags are in the system between the money supply statistics and their economic impacts.

But the most important problem of all in using monetary theory for predictive purposes is that monetary theory tells us that our economic situation is not the result of the money supply alone, but of the product of the money supply and its velocity. The difficulty is that there is no useful measure of monetary velocity. The only way we know what the velocity of money has been is to divide GNP by the money supply at some previous time. That provides some interesting retrospective analysis, but is of little use in terms of telling us what to do next. That is particularly true because, contrary to some earlier assumptions, velocity can change abruptly. It dropped sharply in the '81-'82 recession after a long period of steady increases, though whether that was a cause or effect of the recession is far from clear.

Up to now I have been discussing the problems we politicians have as a result of the inadequacies of economic theory and predictions. In fairness I should make it clear that there are times when our politics cause us to fail to use what economics can tell us.

I consider the 1986 tax bill to be a classic example of that. The bill achieved a goal that many have had of reducing marginal tax rates by eliminating many exemptions and deductions. Whether that was good or bad is a matter of some contention. What is important is that the politics of the bill led it to contain very substantial reductions in personal income taxes, while increasing by a like amount business taxes through elimination of most of the investment incentives for business involved in the accelerated cost recovery system and investment tax credit provisions of the 1981 tax bill.

Did that make sense? Let me preface my answer by stating that in my view one of the major problems we have as a nation is our low savings rate. Though the statistics are far from reliable, there is a consensus that our savings rate is substantially lower than that of the rest of the industrialized world. Japan, for example, has a budget deficit comparable to ours as a percentage of GNP, but its high savings rate enables the deficit to be financed internally without problems.

Why we have such a low savings rate is not clear. In February 1981 a group of us led by then Rep. Henry Reuss, who headed the Joint Economic Committee, and by then Rep. Barber Conable, who was ranking Republican of the Ways and Means Committee, visited Canada to try to find out why the Canadian personal savings rate was twice that of the U.S. We spent several days visiting bankers, labour leaders, economists both within and without the government, other government officials and the like.

" Ultimately it seemed clear to us that the superior Canadian savings rate was heavily influenced by the non–deductibility of interest on personal borrowing and the large number of tax–exempt savings schemes available. "

Some time thereafter I attended a reception at the Canadian consulate in New York City and recounted all we had learned to a Canadian who had been rash enough to ask me if I had visited Canada recently. He heard me out, looked down his nose at me, and commented, "You know, that's all rubbish. The reason we Canadians save so much more that you do is that we have so many more Scots than you do!"

In the face of that comment, I shall not try to develop any comparative theory of savings rates. But it is worthy of note that there were two parts to the 1981 tax bill. One part, as I indicated, consisted of the business tax incentives. The other was the personal tax cuts. From a savings and investment point of view, the business tax cuts worked and the personal tax cuts did not. Indeed, the economists at the Congressional Research Service tell me that, of the eight post-World War II recoveries, the one starting in 1982 had the highest business investment rate and the lowest personal savings rate of any of the eight. So, in a nation very much in need of savings and investment, it was plainly politics rather than economics that created a 1986 tax bill that did more of what did not work – from a savings point of view – in the 1981 tax bill and paid for it by repealing what did work! The public knows when it receives a personal tax cut; even the most learned economists have difficulties in telling us how a business tax increase is divided among investors, employers and consumers.

In fairness I should note that the 1981 personal tax cuts may have worked from a Keynesian point of view by supplying more funds for consumption as the '81-'82 recession struck. But Keynesian economics would also say that those tax cuts should have been repealed as the recession turned into a recovery and the deficits persisted.

Permit me some final observations. Given the uncertainties that prevail as to economic predictions, one can wonder if popular expectations do not drive the economy as much as any other factor. When I was studying the "dismal science" as an undergraduate at Harvard 40 years ago, the assumption was that an increase in the money supply would reduce interest rates; an increased supply in the face of a fixed demand for funds would produce a lower equilibrium point. Today, the expectation is quite the opposite, as the increased money supply causes an expectation that the Fed will tighten up. The idea that expectations can overwhelm other parameters of an economic model is not a novel concept. Oskar Lange proposed such a model many years ago.

If that model is an accurate one, then, for reasons quite different from those the monetarists have proposed, perhaps the steady state economic policy they propose makes sense. Put in today's terms, a firm commitment by the political leadership to move steadily toward a balanced budget and a firm commitment by the Federal Reserve Board to hold money growth at a fixed rate may be the best the political system can do to manage the economy. At the least, it provides the business, labour, and financial communities with some sense of direction. It is not much, but it may be the state of the art!■