

Commentary: Macroeconomic Policy and Long-Run Growth

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I'm going to talk a little more about some of the things that Larry Summers said in his paper.

I certainly agree with Larry's point about independent central banks and inflation. I also agree, at least in part, on the issue of equipment spending and equipment investment. I do, however, want to point out some numbers in the 1980s. Larry mentioned that productivity rates declined somewhat less in the United States than in some of the other countries, and that the U.S. decline is mostly a function of the long-term deterioration in American productivity. I'm not sure I agree with that. Certainly, on the equipment side, the United States had quite a burst of investment according to numbers in the national income and product accounts. During the expansion from 1982 to 1990, equipment was up 46 percent in real terms—5.6 percent at an annual rate. The other point I'd make is on equipment as a share of the overall economy—we were talking about, gross national product (GNP) or gross domestic product (GDP) shares in the earlier panel. From 1980 to 1984, equipment as a share of GNP was 7 percent and, from 1985 to 1989, equipment as a share of GNP was 7 1/2 percent. From 1959 to 1990, the average was only 6.3 percent, so the 1980s saw quite a surge in equipment spending in relation to most of the postwar period.

What did trouble me about Larry's paper; and troubled me even more about Fred Bergsten's remarks, is what I think is a not-too-veiled support for targeted investment, ideally targeted by the government, and presumably by people in this room who would be the targeters.

As someone who was a former targeter, I don't think that works. I much prefer, of course, free market economics and letting rates of return and relative costs and prices determine the allocation of resources—even an important resource allocation, such as investment in new equipment. So I certainly have a problem with targeting investment, and I think we would be in great error to run back to a more planned economic approach.

By the way, I don't think the Germans and Japanese are doing so fabulously right now, to the extent that they have embodied some of these proposals. I will note that the U.S. economy is the only one in the G7 which is expanding. I admit it is expanding at a slow pace. I'm not here to defend the last four years. But we are growing. Nobody else is really growing in the G7. So to some extent, we may be too hard on ourselves. As I listened to Charlie Plosser's paper, I agreed with a lot of what he said. Low inflation is good for economic growth, lower taxes are good for economic growth, and lower government spending is good for economic growth. To some extent, Larry Summers overlapped at least on the inflation parts, so we can agree about that.

I want to use the remainder of my time, however, to make a different point. We talked a lot about physical capital and we talked a lot about human capital—education. Robert Barro is going to talk more about that tomorrow along with Kumiharu Shigehara and others. I'm interested, of course, in financial capital, since I work in the marketplace, at least part of the time, and since I think it is a very important issue. To the extent that the U.S. economy has been in a four-year slump—I don't disagree with that view—I think part of it stems from a less hospitable, even hostile, environment which macroeconomic policies have generated for financial capital. I want to stop and talk about this for a couple of moments. It seems to me that we must have a decent supply of capital to invest in equipment, to invest in new technologies, and even to create the prosperity necessary to build the schools and buy the children the right equipment and supplies. We have to focus extensively on this issue—the supply of financial capital.

I think one of the great mistakes stems from tax and regulatory policy in the last few years, going back to 1986, but also clear through the

late 1980s and the early 1990s. We raised our capital gains tax rate. We have lengthened depreciation schedules. We have given the banking system a very rough go with regulatory policy. We have also experienced income and payroll tax increases. And on top of that, we have had a splendid increase in the rate of government spending—really a staggering increase—and, not surprisingly, in the government budget deficit as well. Many people I talk to in the private sector—business people, investors, and so forth—are concerned that rising budget deficits will cause tax rates to go up in the next few years, thus making the environment for financial capital investment even worse rather than better.

My view is that the policy prescription needs to promote economic growth, to increase productivity, and to accumulate physical capital at a faster rate. I think we have to pay some attention to the incentive structure for financial capital: how it will appreciate in value, whether or not it will be properly channeled into new investments, higher risks, and so forth. A couple of studies from Switzerland, just in the last few months, have suggested that in the wake of the 1986 tax bill, U.S. capital formation now ranks 22nd of the 24 Organization for Economic Cooperation and Development (OECD) countries. Perhaps even more interesting, Stanford Professor John Shoven has estimated that in the wake of the 1986 tax bill, the cost of capital in the United States has now moved to a level which is 63 percent higher than it is in Japan, 26 percent higher than in Germany, and 80 percent higher than in Great Britain.

Now I agree that debt is a problem, and I agree that the last stages of the 1980s' expansion created too much debt. But I also think assets became a problem. Asset values have been declining in recent years, which is making debt far more onerous, simply because the rate of return on investments has been reduced by inappropriate tax and regulatory policy. Capital cost has gone up. That has rendered the assets less valuable, hence the debt is increasingly onerous. Also, U.S. tax policy—partly the 1986 bill and the bills in 1987, 1989, and 1990—still, after all these years, has not resolved the problem of double taxation of dividends, surely an issue related to capital formation. Neither has it solved the problem of the double taxation of retained earnings, surely another issue related to capital formation.

Nor has it reduced incentives which still favor debt finance over equity finance, surely another issue related to capital formation. Nor have we resolved the problems of the tax treatment of capital gains and the depreciation allowances. Neither is indexed for inflation. Surely, these affect capital cost and investment return, and hence long-run productivity and economic growth.

Nor have we, I think, properly addressed the issues of the tax burdens on saving, particularly on the steady and significant increases in the U.S. payroll tax rate, which has surely been one of the major factors in the decline of the narrowly defined saving rate. Nor has U.S. policy dealt adequately with the regulatory costs and treatments in a number of areas all related to business performance, financial capital, and overall capital formation. We still have significant bottlenecks and barriers to investments — investment disclosure, registrations, security offerings, so-called insider trading (which has come up in recent years and may be even murkier now) — to add to the trials and tribulations and the issues relating to corporate governance. To me, all of these create barriers: barriers to economic growth, barriers to capital formation, and barriers to capital investment. This was, of course, the backbone of the supply-side view which emerged in the government in the early 1980s.

I would also raise a point about the federal budget. It seems to me if the budget continues to grow at 11 percent a year, which is what it has done in the past 3.75 fiscal years, we are going to continue to have a major problem. This spending increase, which is partly a function of the stagnant economy and partly a function of the state of policies, has created a budget deficit which was 3 percent of GNP as recently as 1989 — \$130 billion. At the end of this fiscal year, according to the Office of Management and Budget (OMB) and the Congressional Budget Office (CBO), it's going to come in — even excluding deposit insurance — at about \$325 billion, which is about 5 1/2 percent of GDP. That is a quantum jump in four years. You actually change the handle on the deficit from a one to a two to a three. I think this itself has created an inhibiting effect on capital formation and the various incentives.

Nor has this spending, which is a form of government targeting on infrastructure, done much to stimulate our economy. Since we all

agree, the conservatives and the not-so-conservatives, that the economy hasn't performed well in the last four years, I ask, "If spending were the answer, why haven't we done better?" Indeed, we did a little drill in my shop that looked at infrastructure spending and what I call "human resource spending," what one presidential candidate called "government investment." Covering all the accounts—transportation, education, employment, employment training, employment services, and so forth—I find, most interestingly, that George Bush has actually done pretty much what his opponent asked him to do. President Bush very significantly expanded federal spending in these areas, by about \$35 billion or roughly 8 percent a year, in the last four years. Now since the economy has grown less than 1 percent, presumably there is not as strong a linkage between this government direct investment and retraining, education, and so forth, as one might believe by listening to some of the other analyses. We've had it for four years and it has had no palpable effect on economic expansion nor productivity. Maybe we need to spend more—perhaps we should double it from 8 percent to 16 percent. We would have to wait four to 12 more years. But as a trial run, we have not done very well in establishing the benefits of government spending.

I also know as a former green eyeshade at OMB, on the question of building roads, bridges, and tunnels as an employment solution, the experience of the 1930s is relevant. Even assuming for a moment that some of the government spending in the 1930s worked some of the time, let me be the first to advise this group that the situation in the federal bureaucracy, the state bureaucracies, and the local and city bureaucracies is completely different now than it was 50 or 60 years ago. There is very little trickle-down to the local level of this kind of infrastructure spending. You have to get through very aggressive bureaucracies, most of which are heavily unionized, you've got to get through Davis-Bacon laws, you've got to get through the minority set-asides. Each takes a little cut as you get down to rebuilding the FDR Drive in Manhattan or whatever it is.

Finally, I must disagree a little bit with Larry Summers on the very low inflation scenario. I'll take this opportunity to commend the Federal Reserve on maintaining this consistent and successful strategy of low inflation and long-term price stability. Let me note not just the

tax cost of capital, but also the interest rate cost of capital. The difference between 4 to 5 percent inflation and 2 to 3 percent inflation is very significant. Four to 5 percent inflation in 1987, 1988, and 1989 generated an average 10-year government-note yield of about 9 percent. But as that actual inflation rate has dropped, and expectations have dropped to 2 to 3 percent, that same 10-year government note is now yielding 6 1/2 to 7 percent, which is a 200 to 250 basis-point differential. That is a lot of money for corporations, both large and small. So I would submit, for lower interest-rate costs, very low inflation—however you define it, zero or two—is a big plus.

So let me summarize my view now that my time has run out. I'm all for equipment spending and equipment investment. Don't get me wrong—I think it is terrific. We had a lot of it in the 1980s, and I wish we could get more of it in the 1990s. But I think we need to pay more attention to policies across the board which will stimulate larger and predictable supplies of financial capital so that we can undertake the direct business investment, the high risk-taking direct investment, and the new technologies for innovation, creativity, and so forth. This is where the jobs payoff comes from. This is where the productivity payoff comes from. We need to look at capital cost and capital return on a tax and regulatory adjusted basis. Then we need to combine that with stronger restraints for government spending and as low an interest rate structure as possible. These to me are the kinds of sensible macroeconomic policies which will provide the necessary capital to finance the economy, new businesses, productivity, and the education, or human capital, which Robert Barro will be discussing.