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Inaugural Issue
Seek High Growth, Not Deficit Reduction

Economic growth should be stimulated, not dampened, in 1989 so that a gradual reduction of the federal budget deficit can be realized within the context of an expanding economy.

A Matter of Goals

The policy advisers surrounding Michael Dukakis and George Bush are focused on the wrong economic policy goals, emphasizing deficit reductions instead of higher economic growth with little inflation. If their recommendations are implemented, there will be a severe recession in 1989, causing higher budget deficits and only temporary relief on the international trade front. We need instead to focus on policies that will enhance the capacity of the American economy to produce and to compete; deficit reduction should be no more than a secondary goal.

Deficits can be reduced, even eliminated, in an economy with high or low growth—or even in one that is declining. The current almost exclusive focus on deficit reduction ignores the more important question of what level of growth is sought and by what means. The primary policy focus should be on shifting resources to investment (to expand capacity) and to export, without suppressing the level of economic activities. Indeed, it is much easier to reduce the domestic budget deficit if economic growth is relatively strong. The same is true, if only in the longer run for the trade deficit. Finally, cutting the deficit is a negative, constricting goal. It will mean curtailing much-needed programs, ultimately inflicting higher taxes, and suffusing a cloud of pessimism over the economy. An emphasis on growth, on the other hand, allows programs to expand and taxes to remain low; it encourages a positive orientation, without continuing the Pollyanna economics of the Reagan years. (High growth need not be accompanied by significant inflation. In the Kennedy era, 1961–63, the economy grew at 5.3 percent a year, while inflation was below 1.3 percent. In the Reagan era, 1980–87, growth has averaged only a sluggish 2.6 percent per year.)

The Current Consensus

Economic advisers to both presidential candidates have reached a consensus. For example, a recent “consultation” arranged by Jimmy Carter and President Reagan’s Secretary of Labor, Ann McLaughlin, brought together conservative and liberal economists, as well as an assortment of chief executive officers, labor leaders, college presidents, and other opinion leaders. The gathering was informed that its policy recommendations would be presented to the next president after the election. The group focused on the budget and trade deficits and unanimously agreed on the need for drastic cuts in federal spending. The liberals favored in addition major tax increases, which the conservatives opposed.

Similarly, Robert Kuttner of The Boston Globe reports that the National Commission on Economics, a bipartisan group which will present its conclusions

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in March, 1989 (i.e., after the election), is expected to recommend higher taxes and reduced public spending. In other words, the bipartisan commission is to provide the legitimization for the hard choices the White House and Congress fear to make on their own, just as a 1982 bipartisan commission paved the way to modifying Social Security.

The specific goal, according to one consensus report, is to bring the federal deficit to zero by the end of the new president's first term. This would require a cut of some $70 billion in Federal expenditures and a similar increase in taxes, if one accepts the current rosy growth projections of the Congressional Budget Office (CBO). Unfortunately, CBO projections have proved unduly optimistic in most years. Any slowdown in the economy would require still larger cuts. In either scenario, Americans need to reduce their standard of living over the next few years. The general understanding, often discussed informally, seems to be that shortly after the election, the new president will announce the austere measures. He will state that to avoid a crisis, federal expenditures must be cut and (perhaps) new revenues raised. The result will be an induced recession, the fourth such since 1970.

"Consensus economists," such as those who participated in the recent "consultation," believe recession is the quickest way to reduce consumption, enhance savings, and shift resources to support export growth, without causing capacity shortages or severe new inflationary spirals. The desired recession could be brought about by either a sharp cut in federal expenditures or major tax increases next year, or by both. The current recovery is already past its prime, and many economists expect a recession in 1989 even if the economy is not dealt a blow by public policies. Such a recession would quickly reduce the trade deficit, which has remained high because strong American consumption is sucking in huge amounts of imports, even while American exports are robust and growing.

Economists realize that this course would temporarily increase the federal deficit (in a recession tax revenues would fall and outlays would increase). However, they believe that soon thereafter the economy would work its way out of the recession, with its resources realigned toward increases in exports (the main source of new demand during the domestic recession), savings, investment, and productivity. Many economic advisers also favor new taxes on consumption, to encourage savings (the level of productivity is closely correlated to the level of investment, which in turn depends on savings rates) and to avoid rekindling inflation.

Some economists respond to the concern about inducing yet another recession, in 1989, by suggesting that if one did appear, they would rescind the constrictive policies. However, it is quite well established that we do not have the capacity to tell when we are sliding into a recession; only that we are in one. In February, 1980, while serving as a senior advisor to the White House, I argued against a policy of induced recession engineered to curb inflation. However, such a policy was implemented, only for us to discover—in March, 1988—that the economy had been kicked on the way down.

One can, after a while and at considerable cost, reverse course. But the result is a confusing, costly zig-zag policy. In any event, why set out with a policy likely to cause a recession only to call it off when the recession occurs?

Triple Error

The consensus scenario embraced by many liberal and conservative economists is unlikely to work, is unduly costly, and is too narrowly focused in its goals. Recessions are much overrated as a cure. Their effects often last no more than two to three years after the recession itself, since neither the structure of the economy nor people's values, habits, and orientations have been changed in a lasting way. Typically, recessions break inflationary expectations only temporarily. For example, the 1970 recession brought prices down in 1971 and 1972, but the 6.2 percent growth rate of 1973 exceeded the pre-recession level of 5.9 percent. By 1974, inflation reached 11 percent. This led to a new induced recession, which in turn was followed by yet higher inflation—11.3 percent in 1974, and 13.5 percent in 1980—and still another recession. (The 1981–82 recession was not followed by high inflation due to exceptional circumstances, such as the collapse of OPEC.)

Similarly, there is no reason to believe a recession would deal with the basic factors that have caused the trade imbalance. On the contrary, while a recession would provide temporary relief (by cutting consumption and thus imports), it would undermine the nation's ability to build up capacity, the only long-term remedy for trade imbalances. Recessions cause investment plans to be curtailed, discourage workers who seek retraining, and so on.

The consensus scenario also ignores the possibility that a major U.S. recession, which would reduce American imports, might induce at least some economic slowdown in West Germany, Japan and other industrial countries. These countries would then be less able to buy our exports, thwarting a major goal
of the consensus policy. (The debt-ridden Third World, including some of United States’ best clients, is economically exhausted as it is.) A more constructive trade policy is to build up the total volume of trade by increasing U.S. exports rather than curtailing our imports.

The economic costs of recession are enormous. Instead of growing at 3 percent a year or better, GNP would be driven into a decline (it fell 2.5 percent in 1981-82). Enormous economic resources are at stake: a one-year recession “shortfall” in 1989 could easily amount to $100 billion or more, with considerable human suffering reflected in unemployment and other, more extreme effects: suicides, mental breakdowns, and marital trouble. Moreover, the loss would affect all future years, because the post-1989 economy would resume growth from a lower base. Thus, even if growth returned to 3 percent in 1990, this would be 3 percent of a GNP smaller by $100 billion than it would otherwise have been, and the same effect would be carried into future years. In a sense, a GNP slice lost to recession can never be recovered. The opposite, of course, holds true if a higher growth rate can be maintained. and if the nation’s capacity to produce increases, higher growth need not have inflationary consequences. (It might be said that these last observations hold for any year, not just 1989; however, a recession is “planned” for ’89, not any year. At the same time it is true that, for the reasons cited, it is desirable to attempt to achieve higher growth with little inflation in all years.)

A final problem with the consensus economic policy is its single-minded focus on reducing deficits. It is implied that deficit reduction would cure most of what ails us, or at least that it is a prerequisite to any other steps we must take. This is not the first time the country has been promised a single-factor cure by a consensus of economists. Two recently championed “miracle cures” have been lowering the value of the dollar and, before that, cutting taxes—the latter a cure that turned out to be a major source of our current malaise. There is little reason to believe that the reduction of deficits will work much better, especially if administered without regard to other needs of the patient.

A president ought to be guided by a broader vision, seeking to reduce deficits in ways that are compatible with other economic goals, rather than disregarding or undermining them.

CHANGE IS NEEDED

A president ought to be guided by a broader vision, seeking to reduce deficits in ways that are compatible with other economic goals, rather than disregarding or undermining them. Indeed, a strong case can be made that the United States’ primary goal should be to seek a higher growth pathway (after decades of sluggish, ever declining growth rates), combined with low inflation; as noted earlier, deficit reduction should be considered only as a secondary goal.

Incompatible Paces

Change is needed, but close attention to the pace of change is essential for success. The consensus policy, for economic and political reasons, favors a dramatic reduction in the budgetary deficit in 1989. Most compelling is the fear of a calamity. The United States has never had such a high international debt nor been so dependent on foreign investors and ‘hot’ money to finance its high level of consumption. Moreover, the country has surrendered many of its policy tools by stimulating the economy when it was relatively robust; we are hence unable to stimulate in a recession without causing horrendous deficits. It is a mathematical certainty, we are told, that the American economy cannot continue to function in this way, accumulating larger and larger international debts. Sooner or later, the foreigners will refuse to hold ever more American dollars; in effect, they have already begun to diversify out of dollars. Any substantial shock—an attempt on the president’s life, another October 19th-like crash, or the collapse of a major bank—could create panic among the overseas investors, who would rush to withdraw their assets from the United States. In response, the U.S. would be forced to raise interest rates sharply, and would be driven into deep and possibly prolonged recession, if not depression. Only a sharp cut in deficits, it is argued, can reassure the foreign investors on whom America has grown so dependent. Only in this way can a panic be prevented. Thus, we are told, the United States needs a preventive recession. The government ought to engineer one, under controlled conditions, before the foreigners force an uncontrolled one upon us.

Politically, economists point out, democracies are reluctant to take bitter medicine. True, the public regularly ranks the deficit as one of the top domestic problems and politicians talk about it ad nauseam. However, because the potential ill effects of the deficit are only barely visible now and because economists have cried wolf so often on this and other issues, neither the public nor the politicians have much appetite for taking action. Hence, it is argued, the best time to proceed is when the president has maximum support—in the first months after the election (assuming he is elected by a decent margin) and
when Congress itself has the longest horizon, before it faces election again.

Policy advisers talk freely about the "political-business cycle." The rule, followed by many administrations (but ignored by Carter to his detriment), is to take the tough medicine early in the president's term, and present a healthy patient by the next election. Practically, this has often meant causing a recession in the first year of an administration (e.g., 1982–83) and applying stimulative policy during election years (e.g., 1984).

If rapid deficit reduction were a proper cure, such strategies might be valid. However, there are strong economic and social-psychological reasons to prefer a slow-paced, gradual reduction. For such a policy to be effective, the new administration would publicly have to make clear its firm commitment to deficit reduction.

Economists tend to be rationalists; their theories often assume that people will adjust quickly to new information, price "signals," and policy changes. In fact, however, people—corporate executives as well as homemakers—often adjust very slowly. Psychological studies show that once a person makes an estimate, even if it is not disclosed to others, he or she is highly resistant to new information that requires adjusting the estimate. Information readily available must be repeated frequently before it is noted—even if it is clearly in the person's interest and there is no emotional resistance. (For example, people often do not "hear" early signals to save more; it took years before many people opened IRAs, and many still had not done so by 1986, when the rules were changed.) After the October 19th crash, many economists predicted that people would reduce their consumption; I predicted they would not, unless the experience was repeated at least once more.²

This psychological inertia is one reason the decline in the value of the dollar was so much slower to produce benefits than most economists had originally predicted. In many areas, such "stickiness" keeps surprising economists. When the level of economic activity declines, prices often fall much less and much more slowly than economists expect. When President Johnson built up deficits to finance the war in Vietnam, the inflationary effect was not felt for years.

Stickiness is relevant for the issue at hand because of the very different pace of the two policy issues: Consumption can be curtailed quickly, but to build up capacity and to increase exports takes time. Hence, the constricting policies should be slowed down to provide time for the proper economic activities to expand.

Monetary policy can be changed quickly. For example, the Federal Reserve Board (the Fed) raises interest rates overnight. Also, fiscal policy can be changed relatively quickly. Congress does formulate some kind of a budget even if it often takes several months, up to a year. However, significant changes in the level of investment take years to fashion and implement.

It is not reasonable to expect a change in government policies to produce a quick and significant increase in the nation's productive capacity and level of exports. Corporate executives will be cautious in changing their plans to build plants and buy major equipment. Similarly, firms with no export experience learn only slowly how to operate in overseas markets, adapt their products and advertising to local needs, and so on. It takes years to build and equip a new plant; many R&D projects take even longer.

Hence, if constricting large-scale fiscal and monetary policy changes are made quickly, domestic demand is likely to collapse long before international demand picks up.

To provide time for economic capacity to expand, the pace of deficit reduction should be gradual.

²... if constricting large-scale fiscal and monetary policy changes are made quickly, domestic demand is likely to collapse long before international demand picks up...

³Accordingly, a multi-year Congressional budget, showing a firm, gradual trend of deficit reduction, would serve much better than a dramatic reduction.
The political window of opportunity that will open early in 1989 can be used to build such a multi-year commitment. The main difficulty is in inventing a procedure that will make this longer commitment credible. The Gramm-Rudman Act, which set multiple-year goals and an enforcement mechanism of sorts, provided a close approximation. What is needed in 1989 is to find ways to reinforce and refine that approximation. Easier said than done, but much less painful than an unnecessary recession.

But what about the lurking calamity, the economists’ favorite horror story? Will a slow reduction in deficits fail to forestall panic among foreign investors? There is reason to expect that a slow but firmly set trend will satisfy them. After all, they too will realize that the problem of the American economy is a shortage of capacity, not a short-term imbalance or a matter of expectations (i.e., not something that can be fixed by a recession). Indeed, it can be argued that a recession would cause precisely the panic the consensus-economists seek to avoid.

Because the situation is unprecedented, it is impossible to be certain what will prevent or cause such a panic. But we are currently far from an emergency situation. For example, very small increases in U.S. interest rates in 1988 have been sufficient to keep foreigners from rushing to withdraw their assets from this country. After all, Japan—our main source of funding—often runs much higher deficits than the American government does.

Moreover, even if a panic were to occur, there are ways of responding short of creating a major recession. For example, the United States has learned to prevent collapses of major banks and temporarily to flood the system with liquidity (following the October 19th crash). In the event of a political assassination, the dollar might need to be supported for a while, and so on. In short, there is no need to inflict a certain recession on the nation in order to avoid a possible one.

Positive vs. Punitve Orientations

Many economists attach relatively little importance to the method by which a deficit reduction is achieved (though they certainly recognize differences between obtaining a reduction from the expenditures side or from enhanced taxes, as well as differences in multipliers). Fundamentally, a billion dollar increase in revenues, or cut in expenditures, means a billion dollars off the deficit. From a psychological and political viewpoint, however, there is a very significant difference between reducing the citizens’ standard of living and slowing its increase.

People are far more willing to forego gains than to accept losses. This preference has been shown clearly in psychologists’ experiments on betting behavior. People regularly give up a large potential gain in order not to risk a small loss. Similarly, they would much rather take a “sure” thing (e.g., their last raise, now part of their income) over a probable better outcome (a larger future raise).

If the new president chooses not to induce a recession, will he be cynically catering to public weakness of will, avoiding his duty to administer a necessary bitter medicine? I think not. When economists call for drastic measures, as with the oil crisis of the 1970’s, the public senses correctly that there is a more human and yet economically sound way to proceed: produce more.

When the consensus-economists call for cutting the standard of living, some do so reluctantly, some without affect, and some with glee. One recently exclaimed, “We had a party; the hangover is inevitable,” with something of the satisfaction evidently felt by people who talk about AIDS as God’s retribution for our sins. Others observe that Americans “lived beyond their means” and the “time has come to pay the piper” as if Americans were a bunch of over-indulgent children who need to be put on a diet. This punitive moralizing ought to be stopped. The budget deficit was largely caused by an administration that was elected on the basis of a strong promise—to balance the budget. And politically, a policy is much more likely to have solid backing and thus be sustainable if the resources dedicated to increased investment come from new, “additional” GNP, instead of being taken from established levels of consumption (which would be the case if growth were zero or negative, as in a recession).

The new Administration should commit itself to reducing the federal deficit as a proportion of the GNP, not to reaching a certain billion-dollar figure.
M42

Growth in GNP has a powerful impact on the sociopolitical climate. A decline, or even a steady state, produces an atmosphere of stagnation if not decay, a loss of momentum and drive, if not a sense of paddling backward. It means a deteriorating infrastructure, lower corporate profits, cut or cancelled programs, wage give-backs, and intensified social bickering over shares of the shrinking pie. (Witness the recent opening shot in an intergenerational fight over how much we can give the old without "robbing" the young.) On the other hand, a rising GNP allows for at least some improvements on most fronts, and encourages hope, optimism, and social peace.

We must get out of the zero-sum picture of the economy—a picture deeply imbedded in the static economic theory so widely used. This theory generally disregards time sequences and effects. In a typical statement, Sandra Shaber reports approvingly: "Consumer spending is cooling off and freeing up resources to produce for export." This assumes that there is a fixed pie; you increase one slice (exports, or investments), you must cut another (consumption). This, to reiterate, is not the technical resetting of a dial, but cutting health, education, income for millions. Yet such a picture is correct only if we view the economy at one point in time. Over time, we can shift resources to investment and exports without reducing consumption if we pace increases in export and investment to coincide with enhanced capacity; they cannot be rushed anyhow.

**Saving, Investment, and the Dollar**

Before we turn to outlining a pro-growth policy, we briefly discuss the relationship between saving, investment, and the value of the dollar. Everyone is aware that American saving and investment rates are low. We are told we "over-consume"; foreigners finance parts of our investment and our consumption, and we cannot go on like this." This claim begs a question: what are we to fix first and foremost (assuming we cannot simultaneously fix everything, and that to try to do so may be counter productive as well as punitive)? Many economists answer: raise the level of savings, because foreigners finance part of our investment. Thus, in 1986 our net investment was 5.8 percent of GNP, while the savings was only 2.5 percent, and in 1985 5.9 percent and 3.1 percent respectively. (Figures provided by David Meerschman, calculated from OECD national accounts.)

In line with the argument advocated here, if we cannot fix both in short order, raising investment should take priority over raising savings. This can be achieved by increasing our overseas indebtedness, which is a proper policy as long as (a) the additional resources are used to finance increased investment, not increased consumption; (b) our investments yield more than the interest we pay; and (c) the dollar is kept stable or is allowed to rise only somewhat slowly.

There is no specific level of foreign indebtedness at which we reach our limit. Like all conditions, the question of ability to repay is a major factor. If we use additional foreign funds to expand our productive capacity, we will require less belt-tightening at home and increase our capacity to repay. True, we will owe more, but our capacity to pay will increase more rapidly.

This is the point of the second proviso. If we pay, say, 5.5 percent interest in Tokyo, and invest the funds in the USA in resources that yield 7 percent (assuming no currency effect), we gain. Indeed, we should stop prodding the Japanese to save less and consume more. If they wish to save much and invest it in the USA, there is no reason for us to be distressed.

Finally, to the extent that the dollar movements are influenced by our policies (and agreements with other countries), we should stop pushing the dollar down, work to stabilize its value, and in future years allow, if not engineer, its slow rise. There are at least two reasons to maintain a stable or rising dollar.

First, a declining dollar penalizes foreign investors. Hence, as we are for the time being dependent on foreign financing, a stable dollar is much more likely than a falling one to attract investment. To put it differently, a falling dollar will force us to pay more, in higher interest rates for foreigners, to compensate for the present currency losses and the risk of additional ones. A shift to a stable and eventually rising dollar will reduce these rates. (When the dollar was stable, in mid-1988, foreigners bought nearly half of the Treasury notes issued, as compared with 20 percent in mid-1987, after the dollar was falling.)

Second, a declining dollar makes very difficult a reduction in our trade deficit because it requires us to export more and more in volume to pay off a fixed

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*Figures provided by David Elks, Congressional Budget Office. Our projection is for illustrative purposes only. The GNP, obviously, would not grow at the same rate every year, and may well grow slower in 1989, and faster in later years because of the factors discussed in the body of the paper.*
amount of debt. In effect, if we think in “real” terms, the lower the dollar, the longer and harder Americans must work and invest to repay loans we took out when the dollar was higher. To allow the dollar to fall lower is just another way of lowering our standard of living and punishing Americans. Whatever the past usefulness of allowing the dollar to fall and of pushing it lower, at this stage we should use other ways to enhance competitiveness. As it is, we already must export 50 per cent more than we import to pay for our debts.

What Is To Be Done?

The policies discussed next are not “original” ones. Rather, we combine existing notions to form the basic economic strategy we advocate: shifting resources to export and investment—resources made available from growth and not from current consumption.

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How might this be achieved?

(1) Gradually reduce interest rates, but not mainly via the Fed.
(2) Introduce incentives for investment (and savings).
(3) Segregate and invest Social Security surpluses.
(4) Introduce limited, gradual tax increases and cuts in public expenditures as a proportion of GNP. Aim to reduce the budget deficit to zero over eight years.
(5) Avoid a consumption tax (unless it can be made progressive).

These measures are now briefly discussed in turn. Lower Interest Rates. Currently, high real interest rates are the single most important factor in keeping the costs of capital high, retarding investment, and slowing the growth of productivity. If the Fed simply reduced interest rates, it would raise the fear of inflation and soon the “market” would raise the rates (especially the long-term rates important for investment). Hence, rates ought to be lowered according to a strategy Martin Feldstein suggests in The Wall Street Journal: commit the government, in an iron-clad way, to reduce the deficit over several years (I would do so over eight rather than four years, for reasons already discussed). Feldstein reports that such a policy, by lowering inflationary expectations, would reduce interest rates and that a two percent reduction in rates would lower the deficit by $60 billion a year by 1993. It would also reduce the domestic cost of capital, and the interest we pay on our foreign debt. The latter effect would be further enhanced if the dollar were to remain stable or rise slightly, because, to reiterate, under this condition foreign investors would demand a lower premium.

In addition, the Fed should follow a strategy of loosening controls as much as possible without losing its credibility as an inflation fighter, using the various tactics Volker perfected.

Incentives for Investment. Congress should restore the tax investment credit (TIC) using broad categories (to avoid detailed targeting, for reasons discussed below). The TIC should be “fixed” in the process, especially closing loopholes that allow corporations to sell tax losses to one each other and to use leasing gimmicks.

Lawrence H. Summers has suggested that we should limit charges for advertising, presumably because it is not a productive activity. Certainly, by this criterion, lobbying costs should not be covered by pre-tax dollars. Corporations should not be treated as persons, who have the right to petition Congress. Their stockholders, directors, and employees all have this right as citizens. There is no reason to grant them a second right, backed up with the huge resources of corporations. Moreover, there is ample evidence to show that lobbying is used to prevent good government and undermine sound economic policies.

Capital tax gains should be reduced for longer-run investments but increased for shorter-run ventures in order to encourage investment and penalize speculation—as recently argued by Bruce Scott. A small tax on financial transactions and a tax on takeovers should be introduced. Its purpose is not, nor could it be, to stop speculation and obviously, many financed transactions and some takeovers are beneficial. But there is a public interest in slowing down these activities. Corporations should not be put through the chaos that follows many takeovers simply because one or a few asset-players believe there might be a marginal profit in the deal. And if the profit is
considerable and is to be realized quickly, the public ought to gain its share as it did in the windfall profits of oil corporations. Also, a tax on takeovers would repay the public for the large amounts of assets (from low cost loans to tax exempt bonds) corporations often gain from local communities, as documented by the Tolchins in their book, Buying into America. (These assets are often lost after a takeover, as "restructured" corporations move their plants, headquarters, etc.)

To encourage savings, the federal government might increase the amount taxpayers can invest in an IRA. The government might also permit the use of a new IRA to save for vocational education and retraining.

Social Security. An effective way to enhance investment and savings is to segregate Social Security from the budget and invest its surpluses in a portfolio of American government and corporate bonds. Social Security surpluses are rapidly rising from $19.6 billion in 1987 to $36.8 billion in 1988, and are projected to reach $45.1 billion in 1989.

Initially, this move will amount largely to an accounting change. Its main effects will be to show the true size of the deficit and to stop treating social security payments as a regular source of tax revenues to be spent to cover current costs. However, as of 1989, such a segregation will provide a very large pool of resources that can and must be invested for the longer run so that the country will be able to pay off later claims. Some economists argue that it is "naive" to treat social security as a true insurance scheme or pension fund; it should be viewed simply as another tax. We hold that social security always was a mixture of the two (tax and pension) and that it is wise, both for Social Security and for those concerned with savings and investment, to treat it more—not less—as a pension fund in the 1990s and beyond.

Gradually reduce the proportion of the GNP dedicated to public spending, raise revenue sufficient to bring the deficit to zero by 1997. There are many suggestions regarding how to reduce the proportion of the GNP dedicated to public spending. (Such a reduction can be achieved while still allowing for an actual increase in public expenditures.) A proportional reduction can be realized by: reducing farm subsidies (in collaboration with other countries); sharing the burden of defense of the Pacific with the Japanese; reducing our troops in Western Europe (we are entitled to a peace dividend if the current arms reduction approach holds); closing unnecessary military bases (a measure Congress is debating); imposing a federal tax on cigarettes and increasing the tax on alcohol; possibly, introducing a tax on gasoline; strengthening the enforcement of, and closing more loopholes in, the tax code. There are good reasons to reduce if not eliminate the special treatment the tax code now accords to residential housing. It might be contended that such a measure would work against investment. However, as we see it residential housing should be taken out of the investment statistics, modifying the accounting rule that treats expenditures for items that last longer than a year as "investments." Residential houses are not productive assets, they cannot be used to generate goods for future domestic consumption or exports; they are a consumer good in themselves. By classifying them as investments we swell our investment statistics (which historically have been shifting from other goods to residential houses). Meanwhile, the investment of other nations is not only growing much more rapidly but is directed much more to productive assets, not housing. It is argued that people desire housing, but it is well established that past and current tax policies lead Americans to buy much more housing than they genuinely desire. Hence, rescinding the deductibility of mortgage interest—for second homes immediately, gradually for all residential housing—would stop a distortion in the economy and help shift resources to real investment.

No Regressive Consumption Tax. Many economists, including, surprisingly, many liberal ones, favor a tax on consumption as a way to encourage saving while raising significant revenue. Such a tax hurts the poor and favors the rich. Although various suggestions have been made to render a consumption tax less regressive, some of these proposals do not take sufficiently into account the way people actually behave. For example, it has been suggested that a consumption tax be imposed on most items, but that the poor be given a rebate. This is a version of the old idea of a negative income tax. People with little or no income would still file a tax return, to serve as a basis for a "refund." Unfortunately there is strong reason to believe that, faced with higher prices for food, rent, and so on, people would be forced to buy less of those goods, simply because they will be short of funds. The annual "refund," instead of being carefully allocated, a few dollars a day, to make up for higher prices, is likely to be exhausted in a spree of buying items that are much less necessary (a flashy motorcycle? a party?).

In short, unless a consumption tax is made very selective (e.g., imposed only on items such as jew-
Semi-Targeting: Investment-side without MITI

A new wave of economists is now developing an investment-side economics for the new administration, somewhat as the supply-siders did for Reagan. The investment-siders argue for policies that aim to raise the saving rate, encourage investment, discourage speculation and the use of corporations for financial asset plays, and enhance productivity. They typically are concerned with rebuilding the ability of the United States to compete overseas; they favor investment in human resources as well as plant and equipment; and they maintain that structural policies aimed at specific needs are required to supplement macro-policies (fiscal and monetary). The investment-siders include Lawrence Summers, Paul Krugman, and George Hatsopoulos (who wrote a major unpublished position paper, "Beyond the Trade Deficit"); Lester Thurow, the dean of the Sloan School of MIT; and Robert Reich who dedicated an essay to the subject. Rosabeth Kanter and Michael Dukakis' book, *Creating the Future*, also falls in this category. It shows how government seed money can be used, in collaboration with the private sector, to bring about significantly higher levels of economic growth. This position is to be contrasted with those of both the free-market purists, who wish to "reduce government" and taxes, and let the market decide how much to invest and how much to consume, and the "downers," who wish to tax consumption (a penalty) but provide no carrots to savings or investment.

There are differences among investment-siders, as there are among supply-siders. A main point of differentiation among the former is the level of government guidance sought, although all agree that some such guidance is necessary. Some investment-siders favor a formal national industrial policy. In its more extreme form, this approach calls for setting up a U.S. analogue to Japan's Ministry of International Trade and Industry (MITI). Like MITI, this department would have a "desk" for every industry. The desk officers, in close consultation with business leaders and the relevant labor unions, would develop a plan for their industry. The department top officers would classify the industries as "winners" and "losers." The winners (e.g., semiconductors) would be actively supported with public funds, low-cost credit, and so on. Help would be given to the losers (e.g., steel) to phase out gently (e.g., by retraining and transferring workers).

We argue, as others have, that such a high degree of targeting is very difficult, both technically and politically. Technically, it is difficult for a government department to predict which industries will be winners and losers. For example, textiles were long considered a lost cause in the United States, but now the industry has turned around. On the other hand, the semiconductor industry, once viewed as the winner par excellence, is now considered deeply troubled. Even MITI has made its own share of mistakes.

A greater problem is the nature of the American political system, which allocates resources primarily on the basis of influence rather than merit. Typically it favors old, entrenched industries (e.g., autos) over new ones (e.g., biotechnology). Japan's political system may well be even more corrupt than ours, but its civil service is more powerful and autonomous, and above all enjoys the cooperation of the private sector. There seems to be no way to set up an American MITI that would heed technical information rather than political cues if major resource allocations were at stake.

We favor what might be called semi-targeting. Incentives should be provided for very broad categories of activities, without selecting specific industries to be favored. For example, one might provide more incentives for R&D (e.g., by increasing the tax credit) without establishing a government (or government-industry) committees in Washington to review thousands of R&D projects and decide which ones to support. There will of course be some waste in such a general, semi-targeted R&D incentive; a toy manufacturer, for example, might claim tax credits for redesigning the Barbie doll. However, such waste would be small in comparison with a general distortion of allocations among sectors, such as would result from detailed targeting. It is much easier to determine which activities, rather than industries, to favor—savings, investment, infrastructure, R&D. Because the need for technical knowledge is much more limited and politically influenced, in short, investment policies should be fashioned on a macro and a structural, but not industrial, level.
In Conclusion

Governments, professions, and entire nations occasionally lock themselves into a psychological blind alley known as "groupthink." Those afflicted by this condition come to share a perspective and a direction that they adhere to emotionally and refuse to reexamine. There are some signs that many economists, public leaders, and large segments of the American public have become rigidly committed to the notion that a dramatic deficit reduction is necessary. We argue that the pace of the deficit reduction ought to be slowed down to allow positive macro and structural investment policies to take effect, so that deficit reduction will take place in the context of expanding capacity, a process that cannot be rushed. An economic policy that focuses on finding a higher growth pathway would allow the nation to reduce deficits without creating massive unemployment, social disorder and stress, and a major loss of economic resources. It would also be politically much more sustainable—as it ought to be.

Having passed through eight years of Pollyanna economics, we need not necessarily will ourselves into years of gloom and doom. We need not seek out unnecessary pain to assuage our guilt over the party we never should have had. The time is right for a realistic appraisal of our condition. Both the trade and the domestic deficits are already declining in proportion to the GNP, and given the great potential of the American economy, a round of cautious optimism is called for—not in atmospherics and pronouncements, but in economic policy. An investment-side policy provides a positive road to growth, with little inflation and lower deficits.

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